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BusinessWeek

September 1, 2003

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ENERGY
TO FIX THE
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STRATEGIES

ROBOTS
MOVIE

MARKETING
AM ADAMS
BACK
OLD MAGIC?

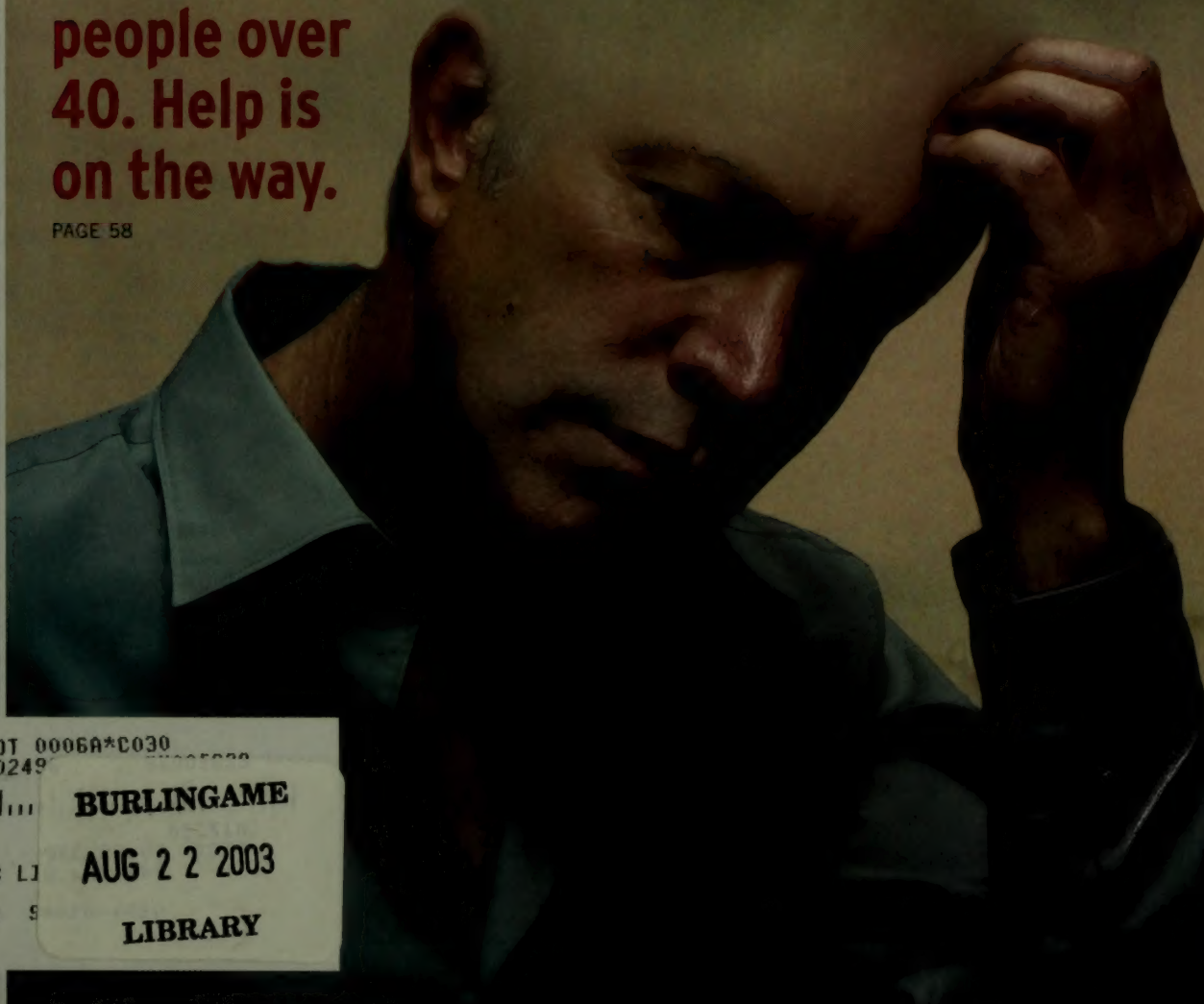
TESTING
NEW MATH
IVING
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LEGAL
AIRS
MUCH
YOU TELL
LAWYER?

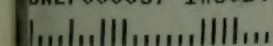
"I Can't Remember"

Memory loss is
a problem for
millions of
people over
40. Help is
on the way.

PAGE 58



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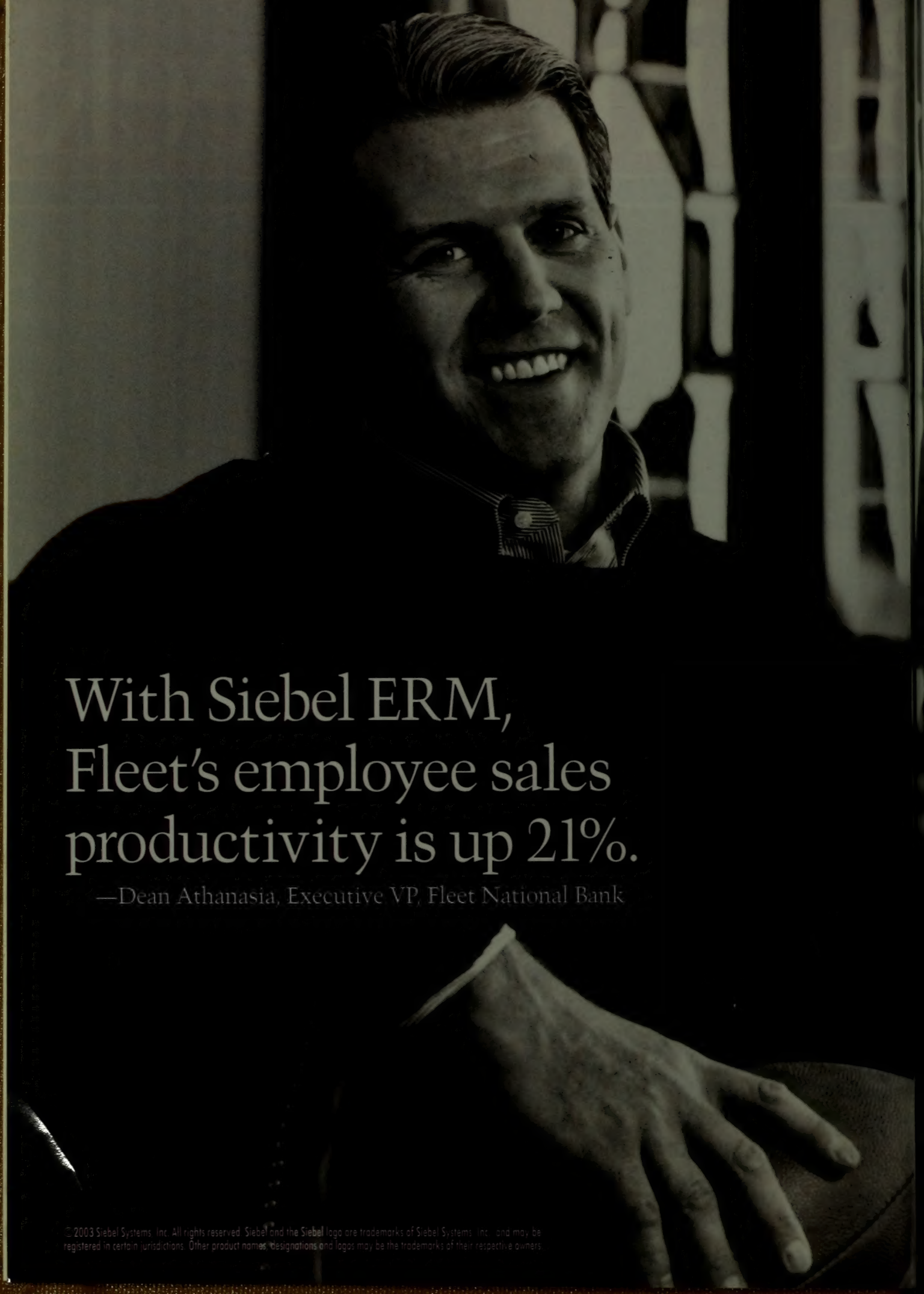


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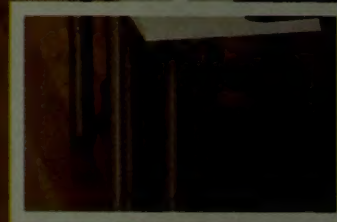
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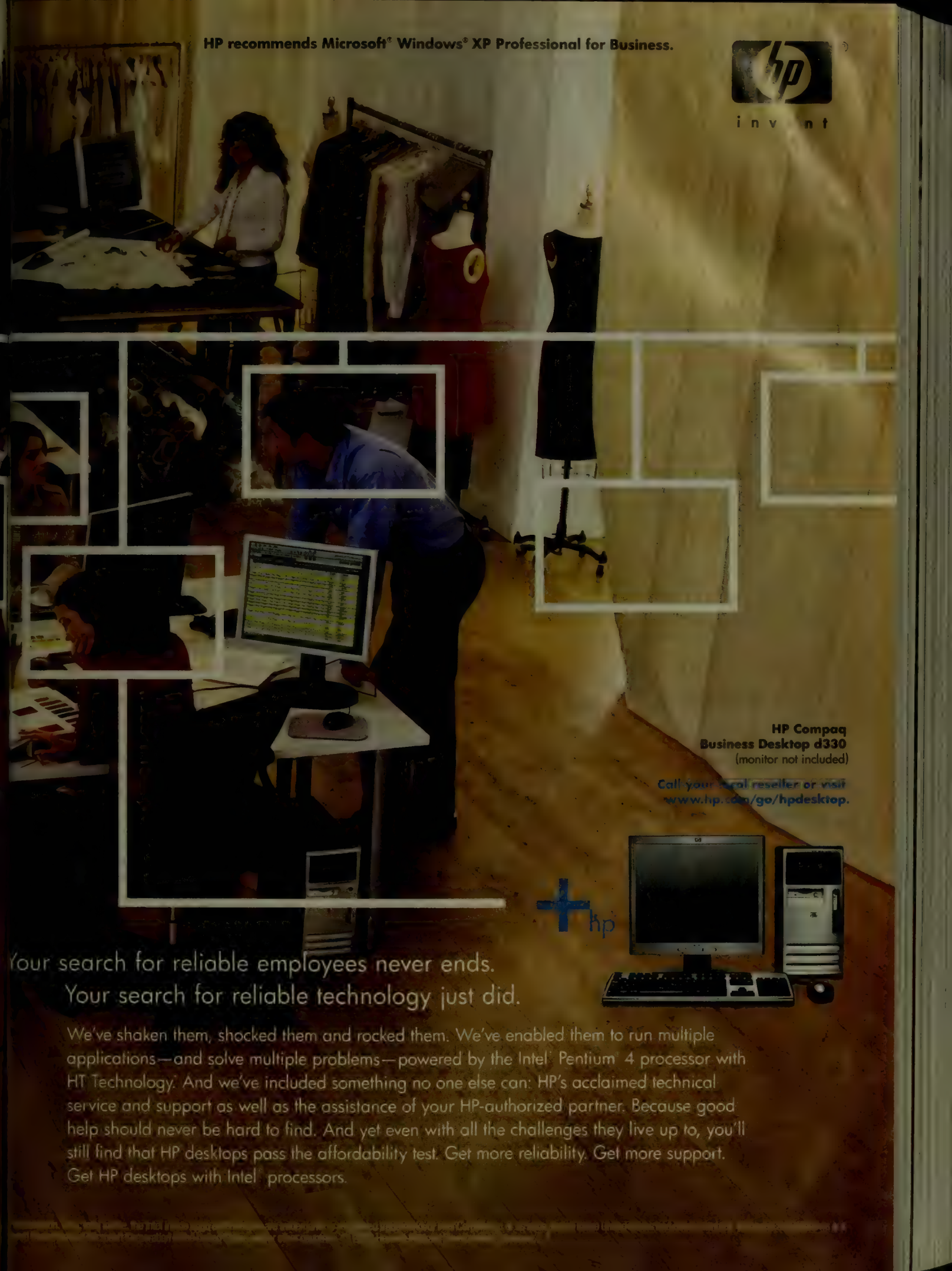
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BusinessWeek

SEPTEMBER 1, 2003

COVER STORY

'I CAN'T REMEMBER'

Short-term memory lapses confound more Americans every day. But help is on the way

page 58



Cover Story

58 'I CAN'T REMEMBER'

With all 77 million baby boomers reaching 50 or older in 10 years, the memory pill business is on the verge of becoming a vast industry. Breakthroughs in drug development promise treatments to ease not only severe memory loss but also the short-term lapses that worry millions. And with more of us living longer, the trend lines for memory loss—and the drugs to treat it—only point up

News: Analysis & Commentary

28 COMMENTARY: FIXING THE GRID

Avoiding future blackouts will be neither as expensive nor as complicated as critics charge. The only real hurdle is political

30 POWER POLITICS

What the President wants and what regional GOP interests will allow are two very different things

32 BUILDING A SMARTER SYSTEM

How to prevent future blackouts: Tougher electricity standards, better info tech, faster switches

34 COMMENTARY: THE SEC

How do regulators scotch audit fraud without killing competition?

36 IS NBC GOING HOLLYWOOD?

Finally, the peacock wants to get bigger. A Vivendi deal would make it much bigger

38 RETAIL'S BACK-TO-SCHOOL LIFT

Tax-credit checks in hand, families are heading to the mall—and the stores are keeping prices down

40 IN BUSINESS THIS WEEK

International Business

44 EASTERN EUROPE: WORKERS

The former Communist bloc countries are rapidly losing jobs to China, where the wages may be 75% cheaper

45 RUSSIA: BANKING

Local and foreign players are courting the growing middle class

46 TAIWAN: ELECTRONICS

With PC sales up but profits down, some companies hope to make the switch to higher-margin TVs

49 INTERNATIONAL OUTLOOK

Why the deadly attack on the U.N.'s Baghdad headquarters may backfire on the bombers

Economic Analysis

24 ECONOMIC VIEWPOINT

Garten: Detroit's Big Three carmakers are heading for a

25 BUSINESS OUTLOOK

U.S.: The blackout was a bl Japan: Deflation's deadly gri

Government

43 WASHINGTON OUTLOOK

How the GOP plans to spend record-shattering \$200 million in Bush's war chest

Design

50 CHINA'S DREAM TEAM

The country's industrial designers are starting to make their mark

Legal Affairs

52 COMMENTARY: THE LAW

How much can executives spend on their lawyers?

People

54 KEEPING SAM ADAMS FROTH

Will Jim Koch's Boston beer be really hip again?

AND
TION
is learning to

ke

AND COOL
enioff stays
pable at
orce.com page 77



ting

TESTOSTERONE AT TALBOT'S
as the menswear market is
ring, the women's clothing chain
going after it in a big way

orporation

CHOVIA'S \$400 MILLION HUNCH
recently closed deal to combine
rokerage with Prudential's is a
contrarian bet

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COMMENTARY: B-SCHOOLS
s are scarce—and schools need
o more to face up to that fact

ation Technology

STRONG: TECHNOLOGY & YOU
gerprint scanners are affordable
rnatives to passwords

EO WHO FOUND INNER PEACE
esforce.com CEO Marc Benioff
bines Eastern spirituality,
rity, and a drive to win

A QUARTER TO FORGET
underwhelming numbers leave
l Street cold



- A wrinkle in college plans page 92
- The hottest Net stocks around page 94
- Audi's A8: Flash isn't everything page 97
- Barker: Is Callaway off-course? page 100



SEALED LIPS
The fierce attacks
on attorney-client
privilege page 52

HIP HOPS?
Twentysomethings
aren't guzzling
Sam Adams in big
numbers.
Jim Koch
aims to
change
that
page 54



FOOL'S GOLD?
Some investors just
can't resist a
bankrupt stock page 82



ZAPPED
Above all, blackouts
represent a failure
of imagination page 28

Finance

- 82 BANKRUPTCY: BUYER BEWARE**
Some intrepid investors seeking quick gains are still snapping up the stock of Chapter 11 companies
- 83 SAM WYLY'S DAY IN COURT?**
The hiring of a "family friend" as a hedge-fund manager has led to a game of suit-countersuit
- 86 COMMENTARY: MORGAN STANLEY**
A suit against it points up the need for more policing of securities firms

BusinessWeek Investor

- 91 DIVIDENDS**
What makes a great business hotel; lavish retirement homes; PC vs. TV viewing; gizmos for grills
- 92 RETHINKING COLLEGE SAVINGS**
Sweeping change in the tax laws may make other plans more advantageous than the 529
- 94 GET CAUGHT UP IN THIS NET**
Our Real-World Internet Index is up 71%, and good stocks remain

BusinessWeek online

www.businessweek.com

96 BOOK VALUE: WORTH PICKING UP

The measure, out of fashion since the go-go '90s, remains a deft way to gauge earnings quality

97 DISCREET LUXURY FROM AUDI

The new A8 won't turn heads, but it's a class act

98 MY FIRST HANDHELD

Tiny PDAs and other gizmos for the 10-and-under set

99 ONE-HANDED CAMERAS

Digital picture-takers for the surf-and-ski set

99 THE GREAT GPS TREASURE HUNT

Geocaching is a hot new sport that runs on satellite signals

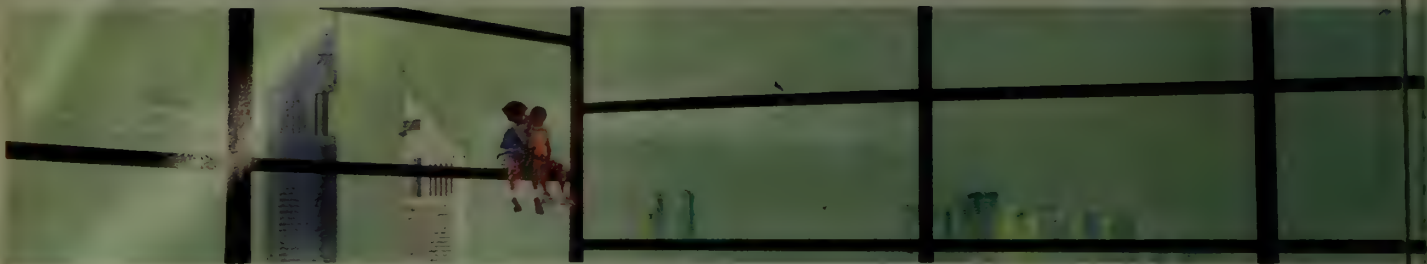
100 THE BARKER PORTFOLIO

Callaway Golf, known for its clubs, is chasing golf balls now. Why?

101 INSIDE WALL STREET

Features

- 12 UP FRONT**
- 16 READERS REPORT**
- 22 BOOKS**
Stanton: *The Prince of Providence*
- 23 BUSINESSWEEK BEST-SELLER LIST**
- 102 FIGURES OF THE WEEK**
- 103 INDEX TO COMPANIES**
- 104 EDITORIALS**



△
TOURISM

△
INFRASTRUCTURE

▽
UNEMPLOYMENT

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CRIME



DUBAI

EXPECT THE WORLD

SEE WHERE DUBAI'S HEADED, TAKE A LOOK AT THE HORIZON.

In 30 years Dubai's business landscape has changed dramatically. The city's GDP has risen steadily by 24% in 4 years. The number of visitors to the city has increased by 54% over the same period. Interestingly, the only things that haven't changed are tax, unemployment and crime. Statistics which would explain why the city's population has also grown by 50%. To know more visit www.dubaexpect.com



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BW's David Henry on how to play the price-earnings game in tech stocks



TOOLS

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Check on the health of your investments



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Use more than 70 criteria to pan for gold among the equities



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Apple's Strategic Shift

Rather than accept being a niche PC maker, Steve Jobs is transforming his baby into a high-end consumer-electronics and services company. This Special Report examines his vision for the future—from iPods to Xserve



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Leaders of industry: Sam Adams' Jim Koch



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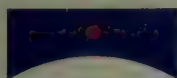
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Up Front

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FOODSTUFF

CHEESY ETHICS FROM KRAFT?

EVER SINCE A SURGEON GENERAL's report said 61% of American adults and 13% of kids are overweight, lawyers have been chewing on ways to hold food companies responsible. Leading the charge is John Banzhaf III, a George Washington University law professor who successfully challenged Big Tobacco.

To take on Kraft Foods,

Banzhaf will focus on nutritional labeling of kids' foods, *BusinessWeek* has learned. Banzhaf claims it's deceptive for Kraft to use adult nutrition guidelines on children's food labels. "It's a deliberate misrepresentation," he says.

The label on Kraft's popular Lunchables pepperoni pizza, for example, says the meal has 10 grams of saturated fat, or 50% of the daily max. But kids under 10 need fewer calories, so 10 grams is 56% of their limit. Morton Hortwitz, a Harvard University law professor, says it's a "no-brainer" that such labels are inadequate.

Kraft spokeswoman Kathy Knuth says providing extra information would be "impractical and certain to lead to confusion." The U.S. Food & Drug Administration does not require separate labels for children older than four, but says it plans to review its guidelines. *Pallavi Gogoi*

STREET TALK

WHEN 'SELL' MEANS 'BUY'

ALL THE SPARRING BETWEEN regulators and Wall Street over analyst research may be overdone. Investors can profit from analysts' advice—as long as they do the opposite.

After Wall Street's 10 top firms agreed to a \$1.4 billion settlement with regulators in April, equity research groups have simplified their stock ratings. In September, Citigroup's Smith Barney analysts will use just buy, hold, and sell. Prudential, Merrill Lynch, Legg Mason, and A.G. Edwards have made similar changes. Already, sell rec-

ommendations account for 11% of ratings, up from less than 1% in May, 2000.

Simplicity does not beget accuracy. Eric Shkolnik, president of analyst rating service MarketPerform.com, studied the top firms during the year ending Aug. 8, 2003. He found that investors who buy stocks hit with a "sell" did better than those who purchase stocks awarded a "buy." At Morgan Stanley the "buy" upgrades yielded 13.5%. But the "sell" downgrades gained 32%. No firm did better with "buys" than "sells." Note to analysts: Call recommendations what you will—just call them right. *Mara Der Hovanesian*



TALK SHOW "...an ongoing national effort by Republicans to steal elections they can't win."

—California Governor Gray Davis, characterizing his state's upcoming recall election

ARNOLD WATCH

HOW MUCH FINANCIAL MUSCLE?

WHOEVER EMERGES AS CALIFORNIA's governor after the state's recall election will face a languishing economy, falling bond ratings, and a huge budget deficit. All of which raises a question about the Republican front-runner, Arnold Schwarzenegger: Does the action star know anything about finance?

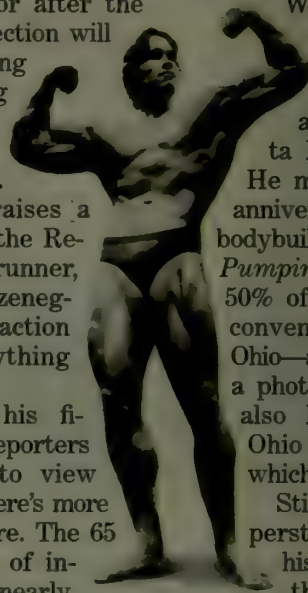
A look at his finances, which reporters were allowed to view briefly, shows there's more than brawn there. The 65 pages list tons of investments and nearly as many financial advisers to handle them.

Overall, Arnold is worth more than \$100 million, much of it in Los Angeles' booming real

estate market. He also owns some \$3.9 million in 2001 from interest, dividends, and bond proceeds. "He's a conservative investor," says his financial adviser, Wachter.

But Arnold is not very high on. He briefly owned a restaurant and then sold it. He marketed the anniversary edition of his bodybuilding documentary *Pumping Iron*, and 50% of an annual fitness convention in Columbus, Ohio—a \$350 pass included a photo with Arnold. He also helped design an Ohio shopping mall, which he owns 20%.

Still, the muscular superstar makes most of his money in front of the camera: \$57 million in the past few years. If he becomes governor, he'll be glad to see other income: The job pays \$175,000. *Ronald G.*



ARNOLD: In '76 he was a bodybuilder, but now he's a governor. *Ronald G.*

THE LIST A LONG WAY TO GO



A year after Sarbanes-Oxley, corporate governance is still a concern. Ratings service Governance Metrics International ranked 1,600 companies on governance, scoring each from 1 (worst) to 10 (best). Some of the worst:

COMPANY	SCORE	REASON
KING PHARMACEUTICAL	1	SEC investigation into sales practices
VIVENDI	1	Accounting problems
LVMH-MOET HENNESSY LOUIS VUITTON	1	Big ownership stake by Chairman and CEO Bernard Arnault
XEROX	1	Accounting irregularities
QWEST	1.5	SEC probe of accounting problems
GEMSTAR	2.5	Management shakeup after earnings restatement; SEC investigation
FREDDIE MAC	3	Accounting irregularities, poor disclosure

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Up Front



AFTERLIVES

DAN QUAYLE AT THE TRAILER PARK

FORMER VICE-PRESIDENT DAN Quayle may have said it best a decade ago: "If we do not succeed, then we run the risk of failure." But failure has been good to Quayle. It's what vulture investors like New York's Cerberus Capital Management feast upon—and how Quayle, as chairman of global operations, earns a paycheck.

The ex-Veep recently popped back into the public eye as a potential bidder in the sale of troubled mobile-home maker Clayton Homes. One of Clayton's institutional

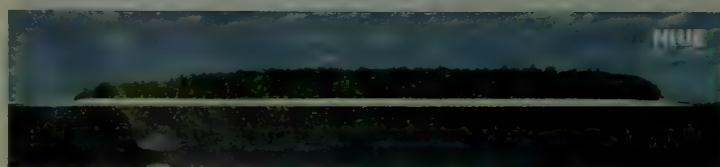
investors has since sued, claiming the \$1.7 billion sale was rigged to favor Warren Buffett's Berkshire Hathaway.

Quayle visited Clayton management just days before the July 31 shareholder vote approving the sale to Buffett.

"We asked Dan to go make sure [Clayton] knew we were serious," says Cerberus COO Mark Neperont. Cerberus, with \$9 billion in assets, declined to bid within the tight deadline. Neperont says Quayle, who was unavailable for comment, is actively involved in all deals.

Thanks to the recession, Quayle has had plenty of deals to look at. U.S. companies have put \$2 trillion in defaulted bonds and bankruptcy assets up for grabs—a record. And Cerberus, named for the mythical three-headed dog that guards Hades, has been on a buying binge. This year it has spent more than \$1 billion on distressed companies such as Formica, Fila, and ANC Rentals.

Mara Der Hovanesian



TELECOM TALES

ALL THIS AND FREE WIRELESS, TOO

THE ISLAND NATION OF NIUE may be just a speck in the middle of the Pacific, but it's a speck with a new claim to fame. Niue is the first country to offer free wireless access nationwide.

It hasn't been easy to get wireless up and running across Niue's 100 square miles. For six years, a band of Netheads have battled iso-

lation, lightning storms, an erratic power system, and a telecom monopoly that refused to grant a license for a wireless transmitter. That inspired island resident Richard St. Clair to craft some low-power solar transmitters—no license required—to carry signals. Now, St. Clair is consulting with geeks in the Philippines, Central America, and Africa, all hoping to rig similar systems. Looks like coconut wireless has met its match.

Kimberly Weisul

DRAWN & QUARTERED

BOBMAN



"YOUR FATHER'S DISAPPOINTED THE POWER'S BACK ON. HE WANTED TO USE HIS VZK RATT

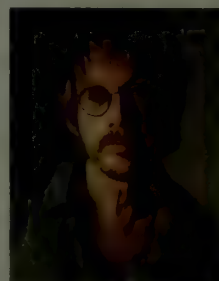
MUSIC NOTES

GOING OUT SINGING

IT'S NOT AN ISSUE MANY music execs ever face: How to promote the final album of a terminally ill artist. But that is exactly what the folks at Artemis Records have had to figure out as they prepare for the Aug. 26 release of Warren Zevon's last album, *The Wind*.

The 56-year-old musician, best known for songs such as *Werewolves of London* and *Excitable Boy*, disclosed last summer that he had a rare form of lung cancer and just three months to live. He has outlived that prognosis, although he is under 24-hour

care. "To promote this as final work would have been in bad taste," says Artemis founder and longtime Zevon friend Danny Goldberg. Artemis has kept things low-key with little advertising. Instead, the budget on the album was increased by an extra \$75,000 for product



ZEVEON: Last work

Of course, the groundswell of media coverage surrounding Zevon's illness helped create awareness of his last album.

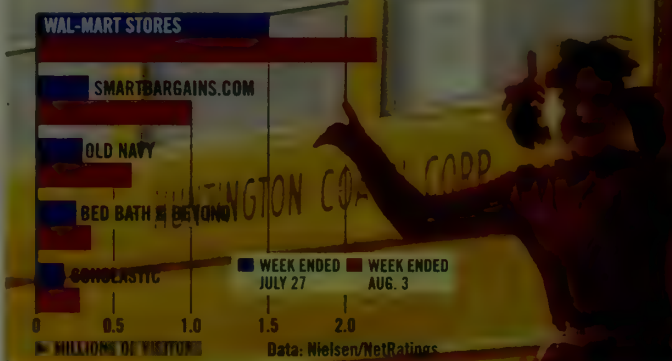
Artemis may have wanted to exploit Zevon's fame, but the artist has no qualms himself.

In keeping with his bit sense of humor, Zevon requested that the first single released to radio be his cover of Bob Dylan's *Knockin' on Heaven's Door*. Tom Lo

THE BIG PICTURE

READING, WRITING, AND RETAIL

Back-to-school shopping is under way, judging from a sudden jump in traffic at several e-commerce sites



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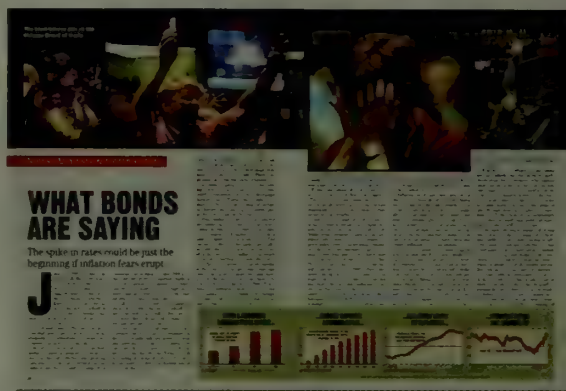
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SOME BAFFLING CALLS ON TREASURY BONDS

U.S. Treasury officials have a horrible track record when it comes to managing the public debt in the interests of taxpayers ("What bonds are saying," News: Analysis & Commentary, Aug. 4). Today's failure to issue 30-year and even 40-year bonds at record-setting low rates is just the flip side of a decision made in the early 1980s. At that time, 30-year Treasuries were callable after 25 years—a call period so extended that it had virtually no impact on the pricing of the bond. Yet, inexplicably, Treasury officials decided at



that time of record-high interest rates to make 30-year bonds noncallable. One of the first issues under that new policy was the 13.25% due in 2014. Thus did Treasury lock the taxpayer into one of the highest rates ever paid on a 30-year Treasury bond.

This lays to rest one of the arguments of the "cons" in your article, since 30-year bonds were paying a lower interest rate than 10-year notes at the time. So, using this logic, we will begin to issue 30-year bonds only when the yield curve is again downward sloping, which, as any bond professional can tell you, is almost always a time of higher-

than-normal interest rates. My suggestion is to begin reissuance of 30-year Treasury bonds immediately but to the foresight to make them callable after 20 years. The danger of not doing so will result in many short-term issues maturing at the same time as debt and interest rates are climbing.

Rod Evans
 Melrose, N.H.
Editor's note: The writer ran the Tennessee Consolidated Retirement System's bond portfolio from 1975 to 1985 and was an institutional bond broker in the 1980s.

BusinessWeek has gone out of its way, like Federal Reserve Chairman Alan Greenspan, to cheerlead our economy out of recession. The bond market is telling us what it told in 1990, 1987, and 1985. It has huge federal deficits as far as the eye can see. If the Fed doves want to continue to keep the printing presses day after night, the bond market is going to respond with higher interest rates. It won't be much longer before the 10-year Treasury note is quickly heading over 5.00% the last two standing legs of the economy, autos and housing, collapse.

Geoffrey Le
 Ventura, C.

NATS OFF TO VERIZON'S VISION

I'm glad that Verizon Communications Inc. Chief Executive Officer G. Seidenberg has such ambitious plans. I look forward to that day in the far future when I have a fiber-optic connection to my home ("Verizon's grab bet," Cover Story, Aug. 4). And w

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Readers Report

Wi-Fi in my neighborhood would be neat in the year 2015, I'd settle for a digital subscriber line in the year 2003.

Michael E. McGown
Dripping Springs, Tex.

I applaud Verizon for its vision. When it succeeds, I will buy its service and quit the services of the other gutless telecoms that are holding back, waiting to see if Verizon will be successful. Verizon understands that to beat the competition, you have to be in the forefront of technology.

G.C. Sozio
Los Angeles

LIVING OFF THE FAT OF THE LAND

The supersizing of the American diet with fat-, sugar-, and salt-laden food attests to the marketing success of our food, beverage, and restaurant industries in eking out growth in a slow-growth sector ("The heat in Kraft's kitchen," *The Corporation*, Aug. 4). All this is not without cost, as the epidemic of obesity sweeps the country.

Our younger generations, nurtured on the unhealthy food choices allowed in school and at home, are becoming the chronically sick workers in our economy, pushing health-care costs beyond globally competitive levels, contributing no doubt to the jobless recovery. As public and private health costs continue their double-digit growth, well in excess of economic growth, pressure is mounting to redefine our dietary practices. Thoughtful investors are already discounting the ultimate consequences for companies like Kraft.

Lee Allen
Boston

THE DANGERS OF DECRIMINALIZING DRUGS

Gary S. Becker recommends decriminalizing drugs in "How to level the playing field for young black men" (*Economic Viewpoint*, Aug. 4). If drugs were decriminalized, then more professional drug-distribution systems would be created. This might eliminate the chance for young black males to receive "better pay," since willingness to break the law would no longer be the main competitive edge as a job candidate. Second, how do cheaper drugs that are easier to obtain help the young black male increase his chances of becoming a responsible father?

Brian N. Balestri
Bloomington, Minn.

Drug dealing is not simply a business transaction: It exploits people. Drug addiction destroys the lives of individuals and their families, compromises the public's safety, and reduces business productivity. Drug addiction can take away a person's purpose and good judgment. If the "dad at home" is a drug dealer or a drug user, I fear for the black son's future.

Isabel Burk
New City, N.Y.

I was blessed with four black children (including one male) and had the awesome challenge of supporting them during an extensive portion of their upbringing—alone. I can assure you that a drug addict/dealer would not have been a preferred enhancement, nor a substitute for the inconvenience of my working as many as four jobs, seven days—and some nights—of the week. My experience is not unique; neither is the fact that all four of my children have at least a master's degree. Black American single female heads of household are too common. But drug addicts do not a role model or head of household make. There is much that Becker is in the dark about regarding living as a black person in America—male and female.

H. Vivian Halliburton
Country Club Hills, Ill.

The cost of the "war" on drugs in dollars and lives has exceeded any return we could ever expect to achieve. I will vote for the first Presidential candidate who finally admits that we have lost the war on drugs and it is time to legalize, regulate, and tax narcotics. Just putting a fraction of the resources required to incarcerate drug offenders into rehabilitation would benefit all society. Not to mention the innocent lives that would be saved when gangs quit the senseless slaughter they engage in to defend their territory.

Rick Schmidt
Portland, Ore.

Every citizen has choices to make about what type of life to lead. Yes, some people have more difficult obstacles to overcome than others. But it's the choices we make as individuals that determine our lives. As an African American male who has made the right choices to survive, get an education, and provide for my family (while working in several low-wage jobs and despite growing up for a time in a broken home), I am offended that Mr. Becker thinks the only way to help black males is to make legal a blatantly illegal ac-

tivity that has devastated black communities for decades.

Kevin L. McCorm
Lake Orion, Mi

GIVE WEARY DOCTORS A BREAK

It's unfortunate that "Is the shift pulling its weight?" (*UpFront*, Jan. 28) wasn't given more prominence, considering the astounding losses incurred by fatigued workers. Extrapolating the data to health care is even more worrying. In addition to financial costs, what is the cost in lives harmed or lost by fatigued physicians? This is an all-too-real concern, considering that newly implemented work rules for resident physicians still expect them to work the first, second, third, and most of the next first shift without a break.

Haig Tcheurekdjian, M.D.
Cleveland

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The Power to Know.



BY LARRY ARMSTRONG

tech&you@businessweek.com

LET YOUR FINGERS DO THE LOG-IN



Fingerprint scanners are now affordable. But they're not yet glitch-free

Remember the sci-fi flicks and spy thrillers of your youth, where the good guys could magically open doors or arm missiles simply by touching a special button that recognized their fingerprints? Companies with exceptional security needs embraced fingerprint scanners several years ago to protect their computer networks. Now, with prices falling fast—you can get a fingerprint reader that plugs into a USB port for as little as \$69—more and more individuals have started safeguarding their computers with fingerprint security.

But to what purpose, I wondered? After all, you don't need James Bond-grade security to keep your kids out of your Quicken files or to rebuff nosy co-workers while you're on a coffee break. You can do the same with a password, and it's free.

So I gathered up a handful of these gadgets to try out for myself. The appeal is immediate, and it has less to do with security than it does with convenience. Not only will they keep your computer's files safe from prying eyes, but the best of the bunch will log you on—at the touch of a finger—to all of the password-protected sites you visit, from bank accounts and frequent-flier programs on the Web to standalone software applications on your computer or on your company's network.

Think of fingerprint scanners as the ultimate in password managers, able to encrypt and keep track of all of your various user names, passwords, and personal identification numbers (PINs). Once you connect the device and load the software, you don't have to look up and input all those secret codes each time a Web page or program asks you for one. Instead, an instruction pops up telling you to put your finger on the sensor. The software then verifies your fingerprint and automatically fills in the log-on name and password fields.

Because the fingerprint readers only work

with—and protect—the computer they're connected to, the security of your Web access still hinges upon how unbreakable your passwords are. But because you no longer have to commit them to memory—or to a sticky note on your desk—you now can make them smarter than your wife's birthday or your pet's name. Security experts say the best passwords are a mix of upper- and lower-case letters and numbers, wQC7a4Ej, for example.

I spent several weeks playing with the gizmos that sit on the desk, attached to the computer's USB port by a cord: Sony's \$140 600 Puppy, coming in September; the DEFCON Authenticator from Targus; and onClick's \$100 BioMouse, a mouse with a built-in fingerprint reader. Because notebooks are particularly vulnerable to theft, I also looked at a couple of sensors designed to slip into the PC card slot of laptop computers: Security First's MS 3000 Authenticator (\$199) and a similar card sensor, onClick's BioScan (\$180). All are for Windows

JUST A TOUCH
BioMouse and Authenticator keep files safe and can track your passwords and PIN numbers

computers (Sony's version for Mac costs \$20 more).

The Sony and Targus systems were the easiest to get up and running, but onClick's BioScan worked the best. It could recognize my log on to more than 100 sites without my intervention (except supplying my fingerprint), and adding new sites to its list was a snap.

If my experience is any guide, though, many users will need help at some point. Sony's sensor mysteriously stopped working after

several days; I called, and they sent a new one. Targus' unit would work with Windows 98 but not Windows XP; a tech support staffer said he'd gotten an older version of the product. onClick sent me new software. OnClick's BioMouse was unable to log me on to my Web accounts; a feature will be added in September.

Also, none of the sensors worked for every Web site. None could log me on to AOL, for example. And many of them were confused by sites with multiple fill-in boxes, such as airline sites with separate fields for reservation, flight status, and frequent-flier numbers.

Despite the occasional glitches, however, they made it easy for me to access my company's network and its many applications—such as my expense account—not to mention most of the Web sites I visit in a typical day. And while the security may not be bulletproof, it's a significant improvement over the Post-It method of password protection.



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THE PRINCE OF PROVIDENCE

The True Story of Buddy Cianci, America's Most Notorious Mayor, Some Wiseguys, and the Feds

By Mike Stanton

Random House • 442pp • \$25.95

A LITTLE CAESAR WITH A BIG FOOTPRINT

When I was growing up in Providence, downtown was dank and lifeless after the business day ended—the emptied streets, like those of so many other Northeastern cities on the skids. It was a nowhere burg going nowhere. Manufacturing had moved South, shoppers were heading for suburban malls, a decent restaurant was almost impossible to find, and the nightlife was a barfly's lament.

But that was 40-odd years ago. Now Providence, at least on the surface, is a city remade: rivers rerouted, streets redirected, historic buildings preserved and repurposed, an ambitious center-city mall filled with national retailers. Today, the arts are encouraged, and there are upscale restaurants and taverns aplenty for the gentry.

At the center of the unexpected Providence Renaissance—or certainly grabbing most of the credit—was an unlikely urban hero, a baby-faced Borgia named Vincent Albert “Buddy” Cianci Jr., who for a time seemed a public man destined for a stage far larger than the seedy sideshow of local politics.

In *The Prince of Providence*, Mike Stanton, a Pulitzer Prize-winning investigative reporter for *The Providence Journal*, delivers a riveting, intricate portrait of a pol on the make and the take—a book that will shock and amuse those unfamiliar with a town where corruption is bred in the bone.

The pudgy little son of an Italo-American doctor, Buddy is doted on by his mother and sent to a private school on Providence's WASPY East Side. In a city then split among the old Yankee elite, the Irish who had seized political power, and the Italians who coveted it, young Buddy finds himself a bit out of place among the sons of brokers and bankers from another part of town.

Yet Cianci throughout his life seems to relish the role of the cocky outsider.

He grows up to become a brash young prosecutor and a Republican, which in Rhode Island is like being a Methodist at the Mormon Tabernacle. He almost nails Mafia kingpin Raymond Patriarca for murder and handles another high-profile case involving official corruption. Notoriety follows, and Cianci is emboldened to challenge the hard-boozing Democratic mayor, Joe Doorley, who once bragged he could drink more draft beer than all his rivals combined.

In 1974, Cianci runs as a crime-busting reformer, but what follows his election is an almost 10-year orgy of graft, corruption, sleaze, and outrageous behavior that frequently borders on farce. The Little Caesar of Providence surrounds himself with a lineup of crooks and cretins out of an Elmore Leonard novel. They steal everything that isn't nailed down—including manhole covers.

Still, to the national party, Cianci is a young Republican with promise—a quick-witted newcomer who has somehow taken power in a Democratic stronghold. President Gerald Ford asks the mayor how he did it. Cianci rubs shoulders with Henry Kissinger and Donald H. Rumsfeld and speaks at the 1976 Republican National Convention.

Then, in the midst of a stormy divorce in 1983, the mayor summons a wealthy contractor, supporter, and alleged lover of his wife to his carriage house. In the presence of a menacing police bodyguard, a former judge, and the Public Works director, Cianci launches into a long night of threats and assaults—singeing the petrified builder with a cigarette at one point.

Cianci eventually pleads guilty to felony assault and is forced to resign. It appears that an erratic reign of greed,

venality, and bombast is over as Buddy toupee askew, slinks off into the sunset on Narragansett Bay.

But no—the guy has more lives than Glenn Close in *Fatal Attraction*. During six years in the political wilderness, Cianci gets his hands dirty in real estate and becomes a popular radio talk-show host. In 1990, he impulsively runs for mayor and is elected with a 317-vote margin. The Buddy Show is back in prime time.

A humbled Cianci promises a new era of good government. But the arrogance is evident at a sit-down with business leaders. Cianci lectures G. Hassenfeld, then CEO of Hasbro: “Let's get one thing straight. You run f— toys. I run a city. I have a police department, a fire department. You make f— toys. And the only reason you do that is because your father gave you the company, because you are a member of the Lucky Sperm Club.”

For all of the rollicking Nineties

on into the new century, Cianci presides over a city. Stanton calls the mode the new American city. The Providence Renaissance takes shape, his approval ratings soar, and he is hailed on national TV. Behind the showboating, though, the city is still for sale.

In the end, Cianci is done by a dogged FBI agent and a team of federal prosecutors, though the best

can muster is a one-count conviction (out of 12) for racketeering under the broad Racketeer-Influenced & Corrupt Organizations Act. The mayor is sentenced to five years, which he is still serving.

While Stanton captures the playful, caustic cadences of the local vernacular, his prose is workaday at best, often riddled with repetition. Yet his shortcomings fade in the face of what is an intense, exhaustive portrait of a bald, craven, self-aggrandizing, totally gaging political animal. At one point, Cianci says that his only crime was loving Providence too much. As the mayor might say, that's a lot of f— bull. Buddy's only crime was loving Buddy too much.

BY CIRO SCOTTI

Scotti is a senior editor at *Government*.



INSIDE THE OUTLANDISH REIGN OF MAYOR BUDDY CIANCI AND A CITY FOR SALE

The BusinessWeek Best-Seller List

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LONG-RUNNING BEST-SELLERS

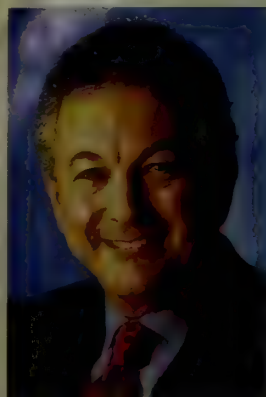
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BY JEFFREY E. GARTEN

DETROIT'S BIG THREE ARE HEADING FOR A PILEUP



GRIDLOCK:
Fierce
foreign
rivalry may
drive U.S.
carmakers
toward
bankruptcy—
or bailout,
which
would be
preferable

Jeffrey E. Garten is dean of the Yale School of Management and author of *The Politics of Fortune: A New Agenda for Business Leaders* (jeffrey.garten@yale.edu).

The Big Three American car companies began talks with the United Auto Workers in July to renew their four-year labor contracts, and they intend to conclude new arrangements by mid-September. Although critical issues such as job security, pensions, and health-care benefits are at stake, the final settlement is likely to be a relatively modest compromise. These negotiations, however, could be a prelude to a far deeper and politically contentious restructuring of the industry. Before this decade is over, the U.S. auto business may go through some of the agonizing downsizing and even bankruptcies seen lately in steel and airlines.

Ford Motor Co. lost more than \$6 billion in 2001 and 2002. Chrysler Corp. hemorrhaged \$1.1 billion in the past quarter alone. In fact, the strongest element of the companies' income is not profits from car sales but earnings from their financing divisions. General Motors Corp., for example, earned more than three times as much from selling mortgages in the past quarter as from cars.

Since the mid-1980s, moreover, foreign auto makers have increased their U.S. market share from 24% to 40%. Now, Detroit faces ruthless competition on the lucrative turf of pickup trucks, minivans, and sport-utility vehicles. Making matters worse, the global auto market suffers from 30% overcapacity—amounting to as much as 20 million vehicles a year. That's more than all auto sales in North America. The crunch will get worse: In the coming two years, Nissan Motors Corp. is planning to increase production by 1 million vehicles.

Perhaps the most intractable problem is that the Big Three bear enormous unfunded pension obligations and health-care costs for hundreds of thousands of retirees, while their own employee base is shrinking. Of Ford's annual \$2.8 billion health bill, 70% goes to retirees. GM has 2.5 retirees for every active worker. Japanese carmakers have avoided such burdens by generally employing younger, nonunionized workers. Little wonder that Moody's Investors Service gives Toyota Motor Corp. a credit rating of Aaa while classifying Ford and GM as Baa—the low end of investment grade.

To be sure, Ford and Chrysler have survived near-death experiences before. This time, one way out would be for Detroit to outdo its foreign competitors massively in productivity and quality. But surveys by J.D. Power & Associates and Harbour & Associates Inc. show that, although the gaps between U.S. and Japanese

producers have narrowed, they are still significant. Alternatively, some American makers get a dramatic lift from introducing a sleek blockbuster models, as Ford once did with the Taurus. But this kind of boost is likely to be temporary. Fact is, Detroit's condition will probably continue to worsen, while that of Japanese rivals gets stronger.

When the day of reckoning comes, two scenarios will emerge: bankruptcy and bailout. Senators in Washington will want natural market forces to handle the adjustment to an auto industry that is dramatically downsized and predominantly Japanese-owned. They would accept a bankruptcy or two, allowing the severing of contractual obligations to retirees, as well as moving production outsourcing to China and other places where costs are much lower.

But other Washington players will argue for substantial government assistance conditioned on radical corporate restructuring. The Big Three and the unions would have to agree to close many more plants and to expand their investment in more competitive technologies. Health-care benefits for current workers and obligations to retirees would be gradually phased back, but far less drastically than in the case of bankruptcy. Considerable foreign outsourcing will be allowed, but within parameters. In return, Washington would provide certain loan breaks and loan guarantees and it would assume some pension and health-care obligations.

Of course, it would be better if the auto companies, together with their unions, radically restructured themselves voluntarily, but there is scant precedent for that in the annals of American industry. So, of the two remaining choices, they would reluctantly favor a variant of the bailout option. It's not because the management and shareholders of the Big Three have any claim on the public purse, because they surely do. After all, they failed to respond adequately to the challenge from Japan throughout the 1990s; they squandered huge profits toward the end of the decade. But why should workers and retirees pay so dearly for these flawed strategies? To be sure, past and present employees should make concessions, but they also deserve help from the companies—which can provide it only if they survive—and from Uncle Sam.

The global marketplace demands that players be hypercompetitive. With or without Washington's help, the restructuring that lies ahead for Detroit could be deep and painful. A financial miracle, however, that seems inevitable.

JAMES C. COOPER & KATHLEEN MADIGAN

HAT SUMMER BREEZE COULD WAFT FOR A WHILE

The blackout was but a blip, and the quarter could see 5% growth

U.S. ECONOMY

The economy shot out of the third-quarter starting gate like Seabiscuit taking on War Admiral. From retail sales to factory activity to exports, almost all the economic reports were surprisingly positive. Indeed, some economists are beginning to whisper that the economy could be growing as fast as 5% this quarter.

THE DATA ARE BEATING EXPECTATIONS

ECONOMIC REPORT	ACTUAL	EXPECTED
RETAIL SALES	1.4%	0.9%
NEW BUILDING STARTS	1.5	-1.7
INDUSTRIAL PRODUCTION (JULY)	0.5	0.2
EXPORTS (JUNE)	2.4	0.5
U.S. CPI* (JULY)	0.2	0.1

*EXCLUDES ENERGY AND FOOD
Data: BusinessWeek, MMS International

Even if growth does not hit 5% this quarter, the economy's momentum is strong enough to ensure a solid expansion in 2004. A stretch of above-par economic growth will help to soak up excess capacity, turn executive sentiment around, and prompt businesses to add to their payrolls again.

The latest data paint a surprisingly strong picture of the third quarter (table). Retailers were busy in July. Building starts jumped to a 17-year high. Even jobless claims are declining. Meanwhile, inventories are so low that businesses have to start ordering new goods or losing customers. So industrial production is picking up, led by output of high-tech gear. And the most recent price reports indicate that the U.S. is in no danger of falling into a deflationary spiral.

Don't expect the power blackout in the Northeast to be much of a drag. From an economic perspective, the outage is much like a blizzard: Almost all activity was delayed rather than canceled. The blackout may affect the quality of the August data, including output and hours worked, especially since it occurred in the week that the Labor Dept. did its payroll survey. Also, the loss of perishable foods may skew data on restaurant sales and grocery store receipts. But even the record-breaking blackout does not alter the fact that the economy has rebounded up—finally—to a period of higher growth.

WITH A HORSE RACE, the key to success is patience. On that issue, the Federal Reserve has indicated that it will not stand in the way of a strong re-

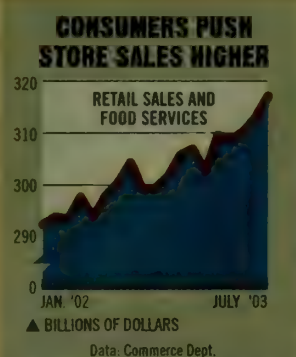
covery. Policymakers kept the federal funds rate unchanged at 1% on Aug. 12, and their accompanying statement said they believe "policy accommodation can be maintained for a considerable period." That's Fed-speak to say, we'll keep short-term interest rates low well into 2004.

For now, the economy's momentum is coming mainly from consumers (chart). Retail sales in July surged by 1.4%, while May and June sales were revised up substantially. May receipts, originally reported to be unchanged from April, now show a 0.5% increase, and the June advance of 0.5% was recalculated to show a 0.9% gain. That means overall consumer spending, as measured in real gross domestic product, powered into the third quarter at an annual rate of 5% or better.

Excluding cars, store receipts in July were up an impressive 0.8%, with gains posted across a wide spectrum of vendors. And according to weekly store surveys, the buying spree continued in August, when the back-to-school season kicked off. The Bank of Tokyo-Mitsubishi retail report said the blackout's effect was "minimal" on nationwide sales.

Households have been able to boost their spending, thanks to the extra money generated by the July tax cuts and cash-outs from mortgage refinancings. But to sustain that buying pace, consumers will need job growth to pick up, and the latest trend in jobless claims offers some hope. New filings for unemployment benefits dipped under 400,000 in mid-July and stayed there into early August. While the level isn't yet low enough to indicate job growth, it does imply that businesses are not cutting jobs as rapidly as they had in the first half. A turn in the job markets will boost consumer confidence and strengthen spending patterns in quarters to come.

HOUSING IS ANOTHER SOURCE of solid momentum. Because of the stronger economic outlook, mortgage rates have come up from their lows of around 5% in mid-June. But at 6% or so, they remain cheap enough to keep home-buying healthy. In July, housing starts beat expectations by rising 1.5%, to a 17-year high of 1.87 million, at an annual rate. In addition, the



Business Outlook

National Association of Home Builders' Housing Market Index surged to 71% in August, the highest reading in more than 3½ years. Current home sales posted a big jump in August, and sales expectations also rose.

The recent gains in overall demand are allaying fears of deflation. Consumer prices in July increased 0.2%. For core prices, which exclude food and energy, the gain was also 0.2%. Inflation may be stabilizing. Since May, total inflation has been running at 2.1%, while the core rate has hovered at 1.5%.

Even the deflation in goods prices may be bottoming out, a result of the weaker dollar's effect on import prices. Excluding oil, prices for foreign-made goods in July were up 1.2% from a year earlier. That compares with a 1.6% annual drop in import prices in July, 2002.

The acceleration in consumer spending has helped to clear out much of the merchandise stocked by businesses. In June, the ratio of inventories to sales at manufacturers, wholesalers, and retailers fell to 1.38, from 1.4 in May. Excluding vehicles at the retail level, the ratio is at a near-record low of 1.31. Skimpily stockpiles are a big reason why orders are picking up and why manufacturing is beginning to show signs of life.

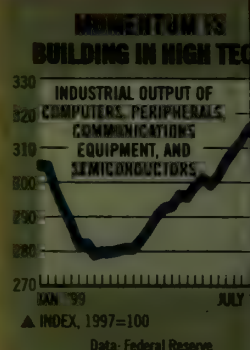
INDEED, SOME OF THE BEST NEWS in recent weeks is from the industrial sector. First came a big increase in the Institute for Supply Management's July index of industrial activity. Next was the Fed's report

showing July industrial production rose 0.5%, biggest gain in six months. Manufacturing output up 0.2%, the third increase in a row.

About half the industries surveyed reported output gains through June. But the most important increases were in capital equipment. Overall output of business equipment has risen by 0.4% for three months in a row. The makers of high-tech gear have been even busier (chart). Output in those industries has increased in each month of 2003, with an average advance of 1%. Such gains in tech output confirm that a capital-spending rebound is under way.

Manufacturing also may be getting some help from stronger demand abroad. In June, the trade deficit narrowed to \$39.5 billion, from \$41.5 billion in May, mainly on the strength of a 2.4% jump in exports—the largest monthly increase in three years.

For now, at least, the economy is galloping into the second half, propelled by accelerating demand here at home, as the benefits of lower interest rates and tax cuts kick in. And the odds are high that stronger spending by consumers and businesses will sustain the economy's faster pace down the home stretch.



JAPAN

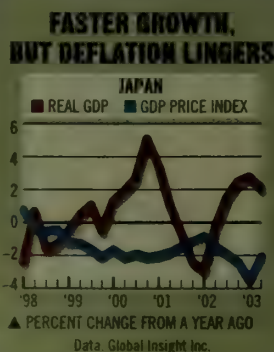
STILL IN THE STRONG GRIP OF DEFLATION

Several recent signs offer hope that the Japanese economy is gaining strength, but deflation and other barriers to growth remain firmly entrenched.

Second-quarter growth in real gross domestic product was surprisingly strong, and the second-half outlook is brighter. Real GDP rose at an annual rate of 2.3% from the first quarter, and data for previous quarters were revised higher, bringing growth during the past year to 2.1%.

In the second half, improving global conditions, helped by a pickup in U.S. growth, reduced geopolitical uncertainty, and the fading SARS epidemic, are setting the stage for stronger exports,

which will boost capital spending. Both sectors showed gains last quarter. Reflecting the economy's better prospects, the Nikkei stock index is up 11% since Aug. 7, to the highest level in nearly a year.



Business outlays are primed for further growth: Corporate profits are already strengthening. Companies' balance sheets look healthier, and manufacturers have shed excess capacity. Indeed, economists at J.P. Morgan Securities Inc. Asia note

that private nonfinancial corporations made net loan repayments totalling a record 30.6 trillion yen (\$260 billion) in the year ended March, 2003, and that manufacturers have cut capacity by 9% in

the past five years, eliminating nearly all of the increase during the bubble years of the late 1980s.

So is this the light at the end of a long dark tunnel? Hardly. Even in the short term, the outlook for household spending is still murky. Deflation's grip on corporations is pressuring them to lift profits at the expense of jobs, and recent hikes in social security taxes are weighing on household incomes.

Deflation will not subside until growth is sufficient to absorb the remaining excesses in production capacity, which may be greater than the official data show. Possibly many companies are not reporting idle capacity that is, in fact, still on their books, because writing it off would be too costly. The rising tide of Chinese imports only makes deflation worse, and structural reform remains slow.



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POLITICAL POWER OVERLOAD

The power grid can be fixed—if Congress gets out of the way

COMMENTARY

By Peter Coy

The Great Blackout of 2003 may be over, but the debate over how to make the power grid safer is running on alarmingly low voltage. Even people who should know better are making statements that demonstrate evidence of rolling intellectual brownouts. Among the myths we've all heard lately:

The U.S. has a Third World transmission system. Wrong.

The main solution is to build more lines to carry power between different parts of the country. Wrong.

Upgrading the grid will be expensive. Wrong.

Here's what's true: The U.S. transmission grid, while imperfect, is still

among the most reliable in the world. Yes, the mid-August blackout was frightening, and it may be a sign of vulnerabilities that still aren't fully understood. But even a good system can fail when an unusual confluence of events occurs. And let's keep things in perspective. The last time there was a blackout approaching the size of this one was 1965, when the Texan in the White House was Lyndon B. Johnson.

While more investment is clearly needed, it shouldn't be poured into tightening the linkages between neighboring sectors of the grid so more power flows over long distances. That would only increase the risk of cascading failures. "In the perfect storm, if one mountain climber slips, he brings everyone down with him," observes Jim Letzelter, a managing director of The McGraw-Hill Companies' Platts Research & Consulting energy service.

As for Myth No. 3, making the more robust needn't be expensive. The Electric Power Research Institute says a complete, state-of-the-art modernization would cost \$50 billion to \$100 billion over the next 5 to 10 years, says Edison Electric Institute President Thomas R. Kuhn. Kuhn says a lot could be accomplished by simply raising annual investment in transmission from its current \$1 billion a year to around \$5 billion a year. Contrast that with more than \$100 billion that's been invested in just the past three years in new generating plants. Today, transmission costs account for only about 7% of utility bills. And what has happened, almost everyone would agree, is that spending a bit more on the grid is cheap compared with sweating (or maybe next time freezing) in the dark.

The fact is that the grid does indeed need upgrading. The obstacle is neither

Staying Switched On: Five Power Plays

FERC'S ROAD MAP

The Federal Energy Regulatory Commission wants utilities to turn over control of their high-voltage wires to one of about eight Regional Transmission Organizations. RTOs could reduce power to portions of the grid in case of shortages. RTOs could also order companies to build new power lines.

TAKE IT SLOW

Some of the larger utilities, including Atlanta-based Southern Co. and New Orleans-based Entergy Corp., are resisting pressure to cede their authority. The

companies claim that keeping control of transmission lines ensures reliability, but critics argue that it results in customers' paying more for electricity.

HIGH TECH

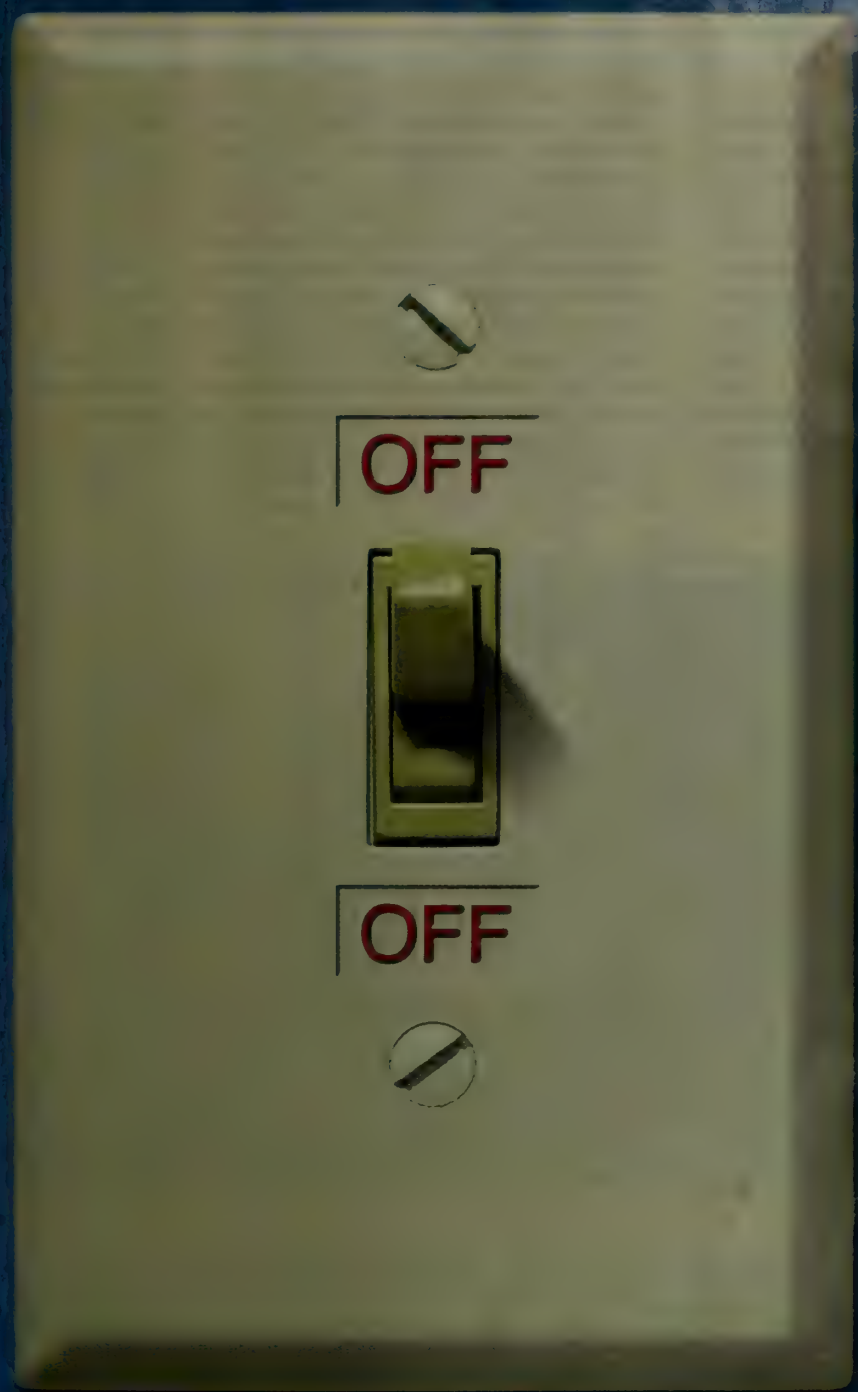
The Electric Power Research Institute, the utilities' research arm, favors a "smart grid" that could operate reliably even near full capacity with the help of sensors and heavy-duty semiconductors that reroute electricity around problem areas. The smart grid could also carry calls and data, allowing utilities to compete with phone companies.

SMALL IS BEAUTIFUL

Conservationists say that instead of disfiguring the countryside with power lines to move power over long distances, the U.S. should encourage more power generation close to customers, preferably from cleaner sources.

RADICAL DEREG

The libertarian Cato Institute, among others, wants to let power line owners charge what the market will bear. Cato also argues that the private sector is best at figuring out the proper mix of more power plants vs. more power lines.



money nor technology. Nor is it a paucity of ideas. The problem is politics. In the absence of new rules from Congress, the electrical grid is trapped in limbo between the vertically integrated industry of the past and the horizontally integrated industry of the future. The result is confusion. No one has both the responsibility and the undisputed authority to make the grid operate reliably. And investors are reluctant to pump more money into the grid when they can't predict the outcome of the political stalemate over regulatory reform in Washington.

That's a shame, because there is one plan on the table that could go a long way toward clearing up authority over grid management and creating clear incentives for investment. It's the plan being pushed by Pat Wood III, President George W. Bush's appointee as chairman of the Federal Energy Regulatory Commission (FERC). Wood understands that the core problem of the

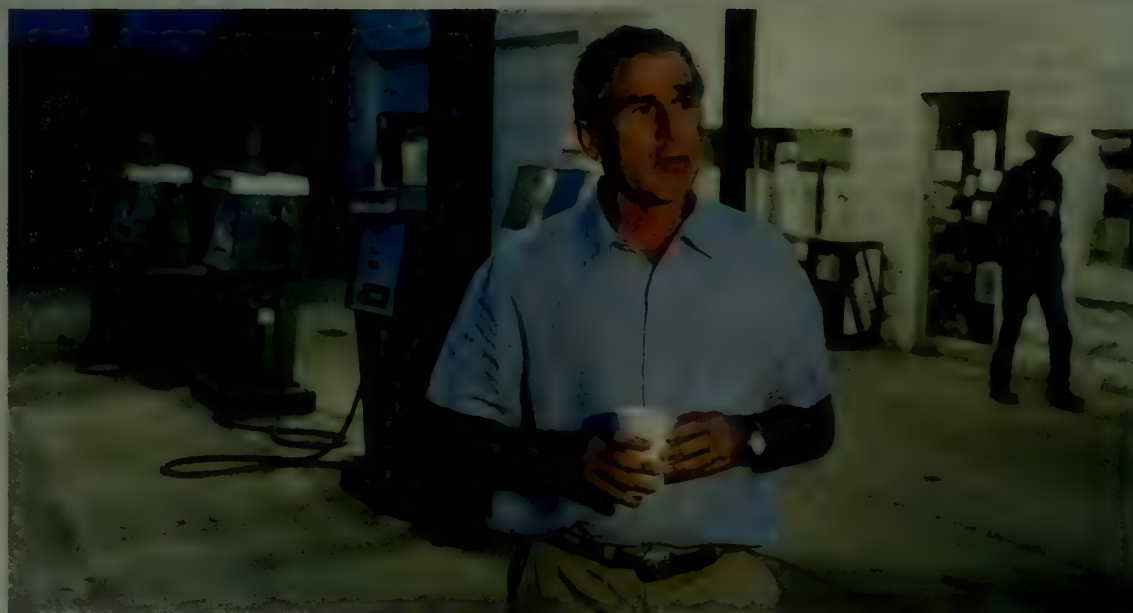
transmission grid is what economists call "the tragedy of the commons." Like a fishing ground or a pasture, the grid is overused when there's no effective means of charging people for it or excluding them from using it.

FERC's plan would create perhaps seven or eight regional transmission organizations with undisputed authority to decide who can use the grid in their regions and when. Companies would also split themselves vertically, divorcing transmission from generation—and then grow horizontally, by expanding in either wires or power plants. The end result: increased efficiency, which would slightly lower the national average retail cost of electricity, the Energy Dept. predicts. More important, the plan would lessen the risk of blackouts caused by underinvestment, miscommunication, incompetence, or Enron-style market manipulation.

Think of the power grid as a network of crisscrossing canals, shared by

all. Generators pour power into canals. Customers siphon it off. Electricity, like water, flows "downhill" follows the path of least resistance regardless of state borders or contractual arrangements. Customers do pay to the transmission grid, of course, because of the way power sloshes around, their transactions may trigger congestion on circuits hundreds of miles away—causing problems that they never pay for.

The tragedy of the commons has intensified since 1996, when FERC triggered an explosion in wholesale power trading by requiring utilities to let other companies send power over their lines for a fee. This lowered the cost of electricity by increasing the use of the cheapest generators available. But it complicated grid management. To balance generation and consumption in balance, control-room operators are constantly negotiating with neighboring control rooms, while asking utilities in their



LITTLE RUNNING RIVER
Bush says he favors regional grids—but powerful state interests oppose them

sion wants to get done what powerful senators protecting regional interests permit are two very different things. The face-off complicates final passage of the energy bill so dearly desired by the President. That has Bush in the unusual position of officially distancing himself from his own appointee.

Politicians in the Southeast and Northwest, led by Senator Richard C. Shelby

(Ala.) and a host of GOP governors, asked the White House to delay efforts by Federal Energy Regulatory Commission Chairman Pat Wood to deregulate electricity and force utilities to join regional grids.

Westerners don't want to give more authority to string transmission lines across private land. Southern states resist the Wood plan would raise the issue of usurping state regulation, and subjecting utilities to the vagaries of the Northern market. "Utilities in the Southeast are not investing billions of dollars in upgrading the transmission system," says one industry aide. "We don't think we should be asked to sacrifice to benefit the North-

CROSSED WIRES ON CAPITOL HILL

When the lights went out from Detroit to New York, alarm bells went off from Bush campaign headquarters to Capitol Hill. That's because electric-power politics is such a mine field.

Certainly, the President has been ahead of the curve by promoting tax incentives for utility modernization and

regulatory changes to ease construction of new transmission lines as part of his comprehensive energy plan. "Now is the time for the Congress to move and get something done," a vacationing Bush told reporters outside a Crawford (Tex.) gas station on Aug. 19.

But what Bush's handpicked head of the Federal Energy Regulatory Commis-

as to crank certain plants up or n, or even to "shed load"—lingo for ing off the juice to some customers. the U.S. grid is fragmented into e 120 control areas, and even inside t of the areas, operators can make requests of utili- not demands.

he nonprofit re- al transmission or- zations that FERC ts would operate— not own—the es in their areas. ing the regions e and few in num- would give region- operators a broader v of the conse- nces of their actions, while reduc- the need for negotiations between rol areas. And the regional opera- would have full command over all plants in their territories, including a power to order construction of new er lines where needed—meaning no e vulnerability to utilities that are ompetent or won't play nice. FERC is

The FERC plan makes sense. Trouble is, it would create losers as well as winners

also seeking permission from Congress to order the siting of needed power lines, over states' objections if necessary, reducing the power of not-in-my-backyard lobbyists.

FERC's plan isn't entirely command and control. It harnesses market forces where possible. As a carrot, builders of badly needed lines could earn a premium over the ordinary rate of return—one part of the FERC plan that is already in place and working. To discourage overuse of lines, which could lead to

outages, the system would charge customers more for using lines that are already congested. The beauty of the system is that it sends crystal-clear price signals: If certain customers are paying a great deal because they have to import their power over congested lines, it's obvious that there is a need to build a new line that will serve them—or to

locate a new generating plant close by.

If FERC's plan makes so much sense, why isn't it breezing through Congress? Mostly because it will create losers as well as winners. Southern Co., the big Atlanta-based utility holding company and generous political donor, is strenuously fighting FERC. The company argues that the reforms would cause low-priced power to flow out of the region, hurting its customers. But skeptics say Southern's main concern is that its unregulated generating business would lose business to cheaper imported power from the Midwest. Says one federal energy official: "A competitive market doesn't benefit a utility that has 100% market share, because there's only one way you can go from 100%."

Forget the scare stories you heard when the lights went out: America's electrical grid isn't in a shambles. And fixing it won't break the bank. All it takes is sensible policy and the political fortitude to make things happen.

With Richard S. Dunham and Mike McNamee in Washington and Christopher Palmeri in Los Angeles

a Bush utility regulator in caught in a political vise. He ant a showdown with his boss, longly favors a national network al grids. "Regionwide planning is necessary," he told *Business-* at as long as we have this feder- ssing match over jurisdiction, t invest, because they don't y they'll get their money back." s trying to finesse the differ- restating his support for re- nsmission authorities while sig- at he may back a Senate bid to m for three years—well after '04. Why? Because the political y of the blackout makes Repub- vious. Four states that lost e electoral battlegrounds. Bush won Ohio in 2000. Michigan, ania, and New Jersey, carried e, are Bush targets for '04. uture is one more jolt to Bush

in the economically dim Mid- west. "It brings into question federal stewardship of the grid," says Sherry Bebitch Jeffe, a University of Southern California political scientist. "It allows [Dems] to revisit the connection between Bush and the energy patch."

That could be tricky. Democrats had accused Bush of holding energy legislation hostage to the interests of oil-biz buddies eager to drill in Alaska. Now they risk being blamed for blocking needed reforms on behalf of green activists.

"This shouldn't be about partisanship," says House Majority Leader Tom DeLay (R-Tex.). "It's about turning the lights on." Still, it's impossible to remove politics from any solution. The White House wants to please key swing



WOOD
The FERC head says regionwide planning is urgent

states but knows it could get stung if it angers Shelby's coalition. Among states opposed to the FERC plan are Washington and Oregon, Gore country in 2000 and both the focus of Bush attention. Also in the fold are Arkansas, Florida, and Louisiana, where Bush won narrowly.

If the President delays a showdown until after the elections, he can zero in on energy issues with bipartisan support, such as mandatory reliability standards and tax incentives for transmission investments.

Then he can look like an energy visionary—unless the lights go out again. Voters in the dark may think twice about leaving Bush on the power grid.
By Richard S. Dunham, with Mike McNamee, in Washington

ER POLITICS

The Great Blackout of 2003 has cascaded through the American political system. Here are some of the effects it will have:

ELECTION 2004

ation of the blackout was a can nightmare. Among those he dark were voters in four key tates coveted by the White Michigan, Ohio, Pennsylvania, w Jersey. The Dems quickly dictably blamed Bush for fail- pdate the nation's power grid. Voters are unlikely to punish sident, but more blackouts ve him a political black eye.

REGIONAL RIVALRIES

Solving the power problems is complicated not only by partisan concerns but also regional differences that mirror the split within the industry. Some Hill Republicans—mostly from the Northeast and Midwest—want to create a nationwide energy grid. But lawmakers from the Southeast and Northwest prefer local regulation.
RESULT: Even more lobbying dollars will be flowing.

CAPITOL HILL PARTISANSHIP

Democrats say Republican demands to open such environmentally sensitive areas as Alaska to drilling is delaying passage of an energy bill, which includes incentives for utility generation and distribution. GOP leaders say the Democrats are in the pocket of environmental extremists.
RESULT: Political gridlock unless the Administration drops its Alaska initiative.

ENERGY

WHAT NEEDS TO BE DONE NOW

Key steps: Enforce standards and add digital smarts

For a commodity we take for granted, electricity is remarkably challenging to deliver. The national grid that sends electrons to our computers and toasters is, in essence, one huge electrical circuit. The laws of physics dictate that supply and demand must stay in exquisite balance, like a ballerina endlessly pirouetting en pointe. If one transmission line fails, the system must instantaneously reroute power or other lines and power plants will fall like so many dominoes, causing massive blackouts.

The surprise is that the unsung managers of the grid successfully maintain this delicate balance virtually all the time, using automation and their own judgment to keep electricity flowing amid storms, floods, and power-plant crashes. Indeed, problems like those suffered by power lines in Ohio, which may have led to the Aug. 14 blackout, are solved constantly every day on the grid. "This blackout should not have occurred," says William Massey, a commissioner at the Federal Energy Regulatory Commission (FERC). "There was a system failure."

The reasons for the failure—and why some areas of the country, such as New England, did cope—are still unknown. But to those who understand the vulnerabilities of the electricity grid, there's no mystery about the steps that now need to be taken to reduce the chances of future blackouts. They have a vision of a technologically advanced digital system with enough smarts to manage this fragile balance on its own.

Here's what we need to get there:

Tough, Uniform Standards

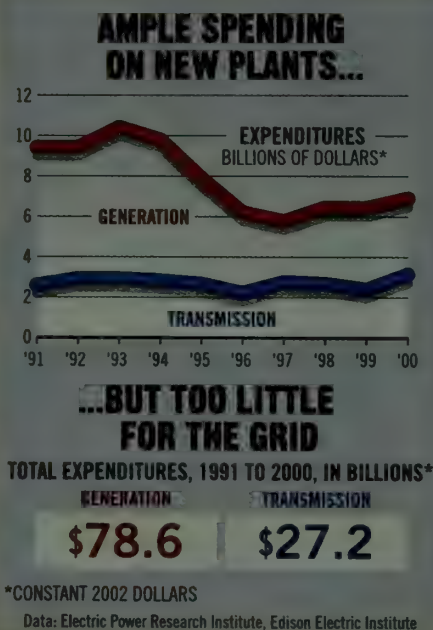
Today's electricity system is a complicated patchwork of hundreds of power plants and thousands of miles of transmission lines, divided up into scores of different control areas, each run by different authorities. After the blackout of 1965, the North American Electric Reliability Council (NERC) was created to set standards and rules for key technical details, such as how precisely the

quality of the electric current must be controlled, or how much transmission capacity must be held in reserve. But the standards are voluntary and are not always met. "The incentive to cheat is universal," says Ralph Cavanagh, co-director of the Natural Resources Defense Council's energy program. That can lead to problems when electrons flow across the seams between regions using different rules. There's a simple, in-

expensive solution to this: mandatory national standards, with NERC cops on the beat to enforce them.

Information Technology

Rapid surges or drops in power can burn out transmission lines and wreak havoc at power plants. That's why each component is protected by relays—essentially, circuit breakers—that open to remove the line or plant from the grid. The problem is that there's no communication between the various parts of the grid. "There is no way for one system operator to know the details of what's going on in other areas," says





Marija D. Ilic, professor of electrical and computer engineering at Carnegie Mellon University. Ilic and others have developed software that looks across seams of the grid and better manages the overall flow of electricity.

Faster Digital Switches

Imagine how hard it would be to ship freight on the railroads if it took 10 days to open and close a switch. That's how slow the current mechanical switches are on the electricity grid relative to the speed of electrons, says Kurt E. Yeager, president of the Electric Power Research Institute. As a result, there is always a split-second delay in responding to problems—which in some instances could be too long. That's why a consortium organized by EPRI is developing digital switches that operate at the speed of light, along with sensors capable of spotting disturbances instantly. With the new technology, the grid would be smart enough to react to problems before they spread. "The key is to make the grid self-healing," says Bruce Germano, vice-president of Long Island Power Authority.

Adding more transmission lines also helps. But the new technology can make far better use of existing wires. A substation in New York is being outfitted with the new digital switches, and it will pass along nearly 200 megawatts more power than before. Adding digital smarts

is one of the big-ticket items in upgrading the grid. The cost is pegged at \$50 billion to \$100 billion over 5 to 10 years. But that's a bargain, experts say, since routine outages alone cost the economy an estimated \$100 billion a year.

Direct-Current Links

The grid operates on alternating current—the same frequency of 60 cycles per second as the stuff that comes out of your wall plug. This makes managing the grid more difficult since small frequency fluctuations on the grid can damage equipment elsewhere. But if the AC power generators were isolated from each other using high-voltage direct-current links, there would be less need to synchronize frequencies. "The grid would be less likely to go out," explains Sarosh Talukdar, professor of electrical and computer engineering at Carnegie Mellon University. A few such links, in-

cluding an 846-mile line between the Pacific Northwest and Los Angeles, have been built. EPRI's Yeager also envisions small direct-current minigrids to deliver higher-quality power to industrial parks, office towers, or residences.

Distributed Sources of Power

If subway systems, hospitals, factories, office buildings, and even homes had their own power sources, blackouts would be far less disrupting. And these small generators—everything from solar panels and windmills to diesel-powered facilities and small turbines—could feed their excess electricity into the grid, reducing the need for new power plants and transmission lines. "In my lifetime, there's going to be a paradigm shift to distributed resources," predicts Shalom Zelingher, director of research and technology development at the New York Power Authority. One reason Zelingher and most other energy experts are sanguine: So-called distributed power schemes can save money, especially when generators are attached to the grid. Companies with their own power sources can use the cheapest electricity—theirs or the

grid's—and also sell excess power back to the system.

Paradoxically, however, attaching many small power sources to the grid increases the potential for problems, since the intermittent electricity generated by these sources would be "just another vehicle to up-

set the delicate balance of the system," says Yeager. Therefore, a grid smart enough to handle the added complexity must be created first.

Once electricity experts figure out the precise causes of the Aug. 14 blackout, they will be able to make immediate fixes to prevent the same chain of events from recurring. And the \$100 billion investment to create the smart digital grid will slash even further the chances of massive blackouts, as well as routine outages.

Of course, technology will never make the system completely fail-safe. "There is no way of guaranteeing that complicated systems will never go down," says Carnegie Mellon University economist Lester B. Lave. But taking these steps will reduce the odds that the lights go out again anytime soon.

By John Carey in Washington, with Adam Aston in New York

**"Distributed power,"
with offices and
homes generating
their own juice, may
become a trend**



COMMENTARY

By Paula Dwyer

THE BIG FOUR: TOO FEW TO FAIL?

The Securities & Exchange Commission is finally getting around to disciplining the auditors who played supporting roles in some of the biggest corporate disasters in modern time. In mid-August, it banned two PricewaterhouseCoopers accountants from auditing public companies after they failed to follow audit rules in reviewing the books of software company Micro-Strategy Inc. and conglomerate Tyco International.

But in both cases, key players appear to have dodged the SEC hammer. The agency didn't pursue other senior partners who signed off on the audits. And it hasn't brought charges against PwC itself, despite citing the firm or one of its auditors for improper conduct three times in the past three months. Moreover, a PwC spokesman says the firm continues to employ the Tyco accountant and stands behind the audits he oversaw from 1997 to 2001.

The mild punishment raises a troubling question that has lurked ever since last year's collapse of

Arthur Andersen: Are the surviving Big Four accounting firms now too few to be allowed to fail—and effectively beyond regulators' reach? Any severe, firmwide sanction, such as a one-year ban on auditing public companies, could put an accounting firm out of business. That would only strengthen the ever-growing concentration of the Big Four. Already, their market dominance threatens to make unworkable an idea the SEC is studying to boost auditor independence—requiring companies to rotate audit firms every five years.

Regulators face a conundrum. They must carry a big stick but not use it to drive any of the remaining big players out of business. The SEC and the new Public Company Accounting Oversight Board (PCAOB), which shares accounting enforcement with the SEC, must foster competition, even if it means asking Congress to open the federal purse to subsidize small firms' expansion.

This doesn't mean SEC officials don't want to be tough. "We can't expect audit firms to correct defi-

ciencies if there's no firmwide penalty after a string of failures," says a top agency official. Yet Andersen's failure shows how carefully they must tread. All but a handful of Andersen clients took their business to one of the remaining four: PwC, Deloitte & Touche, Ernst & Young, and KPMG. A July 30 General Accounting Office report says that businesses audited by the Big Four now account for an astounding 99% of all public-company sales. "It's a national problem," admits SEC Chairman William H. Donaldson. "We're concerned about the long-term implications."

SEC Enforcement Director Stephen M. Cutler won't say what's next in the PwC case but insists he's "deter-

mined to pursue firmwide sanctions." If so, he'll need to be creative. Already, the agency is experimenting in a case against Ernst & Young for allegedly violating rules preventing audit firms from going into business

with the companies they audit. SEC lawyers are seeking to prevent E&Y from accepting new clients for six months. E&Y is fighting what it considers a draconian punishment. Beyond such temporary suspensions, the agency is also going to have to impose hefty financial penalties for the auditors to feel pain.

Fostering competition will be harder. The Big Four dwarf the rest of the profession: Annual revenues of the 20 next-largest firms combined don't equal the \$3.2 billion in U.S. sales of KPMG, the smallest of the Big Four. It could take a decade for one of the second-tier firms to graduate to the bulge bracket by merging, opening new branches, and hiring the staff needed to attract a large corporate client.

To boost competition, the federal government could subsidize overseas expansion of the non-Big Four by awarding them audit contracts at, say, Defense Dept. installations. At the same time, the SEC could encourage large foreign accounting firms to compete for U.S. business, a step that Donaldson says "should be a great opportunity" for them. The sooner he sends out the invitations the better.

Dwyer covers accounting from Washington.

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TELEVISION

THE PEACOCK IS SPREADING ITS WINGS

NBC wants to grow. A Vivendi deal would make it a giant

The hottest new show in TV-land these days is Bravo's *Queer Eye for the Straight Guy*, where five gay men give hapless heteros style makeovers. Now the company that owns Bravo looks as if it is about to get a major makeover all its own. Having shaken off a decade-long aversion to the big deal, General Electric Co.'s NBC unit has emerged as the front-runner for the Hollywood assets of French conglomerate Vivendi Universal, which include Universal Pictures, Universal Television Group, and the Sci Fi and USA Network cable channels.

After weeks of negotiations, GE and Vivendi seemed to be moving closer to merging NBC with the latter's Hollywood assets. The deal, which could be announced after Vivendi's planned Aug. 26 board meeting, would transform NBC from a network into a vertically integrated media giant rivaling the likes of Viacom, News Corp., and AOL Time Warner. Fact is, with network TV viewership declining and NBC worried about life after *Friends*, GE

needs to diversify its entertainment revenues. Moreover, NBC Chairman Bob Wright is mindful that size increasingly matters in the broadcasting industry. "We'd like to be bigger," he says. "If we don't get Vivendi, we'll look for other properties."

For years, GE resisted buying Hollywood studios, arguing that the potential for big-

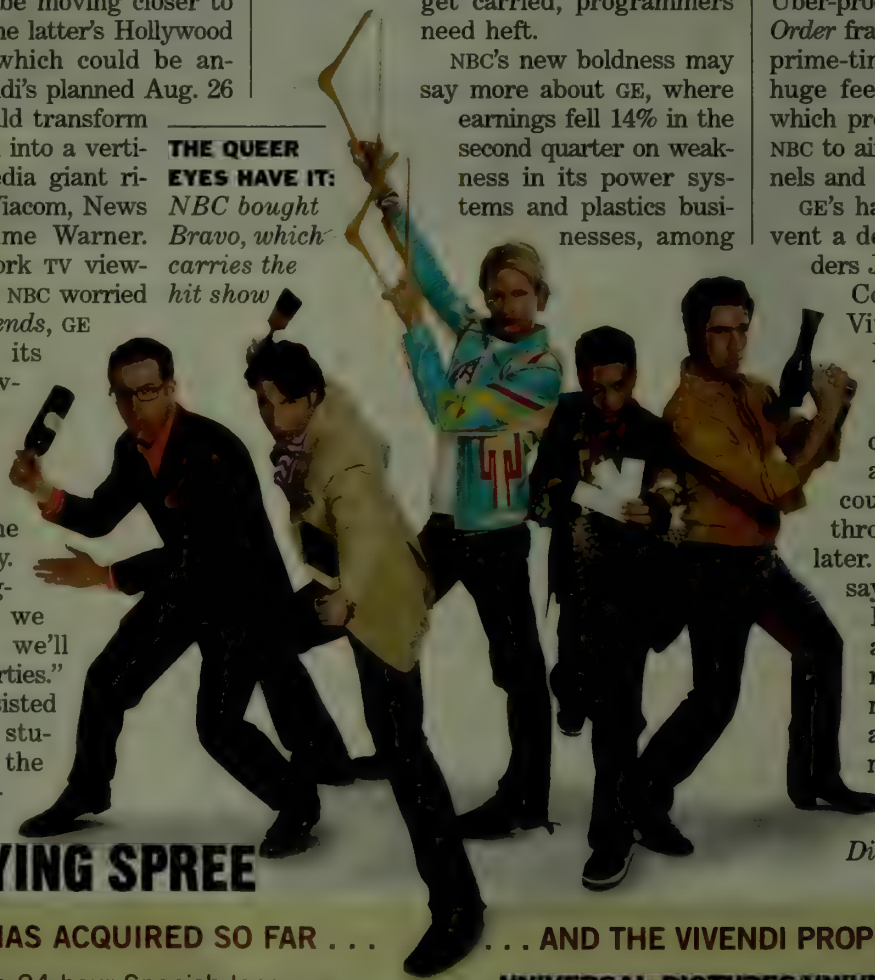
budget bombs made them inherently risky, and that owning one would limit NBC's ability to choose among other studios' hottest TV projects. But today, each of the other five big networks is owned by companies with studios, ensuring them a constant supply of new shows. Distributors are stronger, too: Comcast Corp. now controls cable TV in one-third of the country, and Rupert Murdoch's News Corp. is in the process of buying satellite service DirecTV, with its 11.5 million subscribers. To make sure their programs get carried, programmers need heft.

THE QUEER EYES HAVE IT: NBC bought Bravo, which carries the hit show

NBC's new boldness may say more about GE, where earnings fell 14% in the second quarter on weakness in its power systems and plastics businesses, among



WRIGHT



NBC'S BUYING SPREE

WHAT IT HAS ACQUIRED SO FAR AND THE VIVENDI PROPERTIES IT MAY BUY NEXT

TELEMUNDO The 24-hour Spanish-language network reaches 90% of U.S. Hispanic households **PAID: \$2.7 billion**

BRAVO The cable channel has hit shows like *Queer Eye for the Straight Guy*, *Inside the Actor's Studio*, *Boy Meets Boy*, and *The West Wing* reruns **PAID: \$1.25 billion**

UNIVERSAL PICTURES/UNIVERSAL TELEVISION The movie studio is in the midst of a three-year hot streak, while the TV studio makes the popular *Law & Order* franchises

USA NETWORK Once top-rated, it's still a power with shows like *Monk* and has a No. 5 overall rating

SCI FI CHANNEL Steven Spielberg-produced UFO thriller *Taken* has hypercharged ratings

others. NBC, by contrast, racked up its highest growth of the quarter with a 26% jump in earnings. That may be one reason why GE Chairman Jeffrey R. Immelt has pushed to do more deals in the broadcast unit than his predecessor, J. Edgar Welch. In the past two years, NBC has diversified its operations by spending \$1 billion in cash and stock to buy Spanish-language broadcaster Telemundo

Communications Group Inc. and Bravo. "The combination of Vivendi assets with NBC would be an incredible powerhouse," says Michael Holland, chairman of New York investment firm Holland & Co., a GE shareholder. "They have the possibility of creating major cash flow out of this thing."

The big lure for NBC is Vivendi's cable channels, which would provide a source of new profits. NBC says it will generate operating earnings of \$850 million this year, up 24% from last year. But programming costs are rising fast. Uber-producer Dick Wolf, whose *Law & Order* franchise provides 20% of the network's prime-time schedule, is demanding a huge fee increase. Owning Universal, which produces the shows, would allow NBC to air reruns on its own cable channels and scoop up extra revenues.

GE's hard-nosed style still could prevent a deal from happening. Rival bidders John C. Malone's Liberty Media Corp. and a group headed by Vivendi Vice-Chairman Edgar Bronfman Jr. are offering cash up front. GE would instead give Vivendi as much as 25% of a joint venture, with a guarantee that the French company could cash out for GE stock through an initial public offering later. Still, people close to the talks say Vivendi Chairman Jean-Reine Fourtou figures he may generate a bigger payday down the road with GE's buttoned-down managers. That would give him a front-row seat for NBC's much-needed makeover.

By Ronald Grover
Los Angeles, with
Diane Brady and Tom Lowry
New York

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RETAILING

BACK-TO-SCHOOL IS GETTING HIGH MARKS

An early buying surge has retailers breathing easier

Lulu Flores can thank President George W. Bush for her new cargo miniskirt. As soon as the tax-credit checks arrived, her parents gave her \$200 to spend on back-to-school items. That's \$50 more than last year. On Aug. 18, the 14-year-old New Yorker was at a H&M Hennes & Mauritz store in midtown Manhattan, debating with her friend Heather about whether a clingy \$10 t-shirt will pass muster in the classroom. "I think people are going to be dressing better this year," she says, with a touch of anxiety. "All my friends are buying more."

school promotions. Even hard-pressed department stores are abuzz with better news. Bloomingdale's Chairman and CEO Michael Gould, coming off his best quarter since 2000, says August sales are above expectations: "We feel very good about the business right now."

More money in shoppers' wallets is helping: Tax rebates have given them an extra \$13 billion. And many still have cash left over from refinancing their homes. Plus, retailers are offering discounts on everything from home PCs to cargo pants to woo people through their doors. "When back-to-school sales are up," says Ellen Tolley, a spokeswoman for National Retail Federation, "it's a good sign for the rest of the year."

Retailers could use a little good news. Last year's back-to-school season was "a debacle," recalls veteran retail consultant Howard Davidowitz. In 2002, according to NRF, families with kids age 6 to 17 said they'd spend an average of \$441.60 on back-to-school items, down from the \$456.70 families spent in 2001. Now, spending is finally bouncing back a bit. This year, NRF expects such spend-

skater, or even punk-rock-inspired gear are also popular with teens. All are picking up cargo pants, as well as cargo-styled skirts, shirts, and jackets.

But as consumers drop more dollars in stores, they're on the lookout for bargains. Over 78% of those surveyed by NRF said they intend to buy their back-to-school gear in discount stores. It's a surprise then that stores are putting more emphasis on providing quality. Retailers from Gap Inc. to Children's Place Retail Stores Inc. are offering high-quality merchandise for the same prices as last year. Tara Poseley, senior vice president for GapKids and babyGap in San Francisco, says the chain has improved fit and fabrics this year and also added features such as G-Shield—a teflon-coated twill that resists stains—to traditional items without charging more.

Merchants are optimistic, but they acknowledge that despite a few slow weeks, they're hardly out of the woods. For one thing, consumers now spread

WAL-MART: Discount stores will lead



Chalking Up Sales

Average spending per family on back-to-school items*

1999	2000	2001	2002	2003
\$436.00	\$548.80	\$456.70	\$441.60	\$450.70

*Survey of households with children age 6-17

Data: National Retail Federation

After a tough spring and last year's truly horrible fall season, a surge in back-to-school shopping has some retailers rejoicing. Sure, they're still worried about the rest of the year. But for now at least, prospects look brighter. Bellwether Wal-Mart Stores Inc. says August same-store sales could show the biggest gain in a year. On Aug. 19, Staples Inc. reported a 47% rise in net income, to \$87.8 million for the second quarter, in part because of early back-to-

school shopping. Spending is expected to rise 2%, to an average of \$450.76 per family, or a total of \$14.1 billion. About 65% of that will go to clothes and shoes, with 16% for school supplies and about 19% on electronics.

What are kids persuading their parents to buy? In apparel, the military look is hot this year, while other favorites include strappy tops, plaid kilt "skorts"—a skirt-over-shorts combo—and hooded sweatshirts. Vintage fashions, as well as the long-favored surfer,

out their purchases or even delay them until after school starts. That's Florida's strategy: She'll buy one outfit now and then look around the halls to see what's hot before buying the rest. With so many of students doing the same, stores won't be able to declare the season a success until the end of September—or even early October. After that, they'll be praying for a good Christmas.

By Diane Brady in New York, and Wendy Zellner in Dallas

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EDITED BY MONICA ROMAN

VIAGRA HAS A HEADACHE

THE LITTLE BLUE PILL IS GETTING a little competition. On Aug. 19, Bayer and Glaxo-SmithKline received Food & Drug Administration approval for their impotence drug Levitra. The drug is the first major challenger to Pfizer's Viagra. Analysts say Levitra may be faster-acting than Viagra. But expect Pfizer to defend its \$1.7 billion impotence drug aggressively, even pointing out to doctors that Levitra carries a warning about possible heart rhythm disturbances. A spokesperson for Bayer and Glaxo says the FDA concluded the cardiac issue was not "clinically significant."

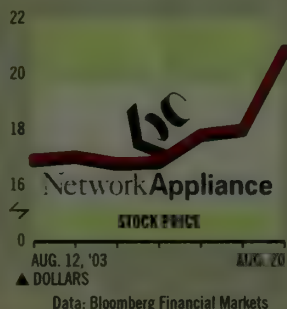
HAMMERING AWAY AT HOME DEPOT

WITH THE BABY BOOMERS NOW in their nesting years, the battle between retailers

CLOSING BELL

THAT'LL SHOW 'EM

For years, investors have wondered when storage maker Network Appliance would get squashed by larger rivals such as EMC. On Aug. 20, it helped allay those fears by reporting a 76% jump in first-quarter earnings. The news sparked a 16% jump in Network Appliance's stock, to nearly \$21.



Home Depot and archrival Lowe's has become the do-it-yourself equivalent of the cola wars. And the second quarter looks like another win for upstart Lowe's, which said on Aug. 18 that profits for the quarter ended Aug. 1 surged 28%, thanks to a heady 17% rise in sales. The following day, Home Depot notched a 9.9% rise in second-quarter profits on a 10.5% rise in revenues. But while Lowe's stock rose \$3, to \$51.96, on its strong report, Home Depot shares tumbled 5%, to \$32.16, as investors decided that Lowe's is winning market share with brighter stores.

RJR: SMOKE, SMOKE EVERYWHERE

THE MOOD IS GLUM ON TOBACCO Road. On Aug. 20, R.J. Reynolds Tobacco Holdings told workers to expect an unspecified number of job cuts as soon as September. The layoff warning comes after the maker of such popular brands as Winston and Camel reported a 67% drop in second-quarter profits. RJR, the second-largest U.S. cigarette maker, blamed the decline on competition from discount brands. The bad news doesn't stop there. RJR's accounting practices are also the target of a probe by the Securities & Exchange Commission. The SEC wants more disclosure about how much of RJR's sales and marketing budget goes toward defense against product-liability claims.

NORTHWEST'S SKIES ARE CLEARING

NORTHWEST AIRLINES WON'T have to break into its piggy bank after all. The nation's No. 4 carrier got the go-ahead from the Labor Dept. on Aug. 18 to replenish underfunded pension plans with stock in a regional-airline sub-

HEADLINER: MICHAEL POWELL

CHANGING HIS CHANNEL

Confronting a fierce public backlash against relaxing media-ownership laws, Federal Communications Commission Chairman Michael Powell is trying to make amends. Powell directed the agency on Aug. 20 to recommend ways to promote local content on TV and radio. But the move will probably do little to slow momentum in Congress to overturn a new rule that allows TV networks to own local stations covering 45% of the nation's audience, up from an original 35% limit.

Powell says public outrage is based on misguided fears that big media will

ignore local programming. He argues that rules to promote such programming would address those concerns. Powell named two task forces to recommend guidelines within a year to promote localism in broadcasting and to promote minority and small-business ownership. He also directed the agency to issue more licenses for local radio stations.

Many had speculated that Powell would step down after pushing through his media regs reform. Now, the betting is he'll stick around to restore his reputation.

By Catherine Yan



sidary instead of cash. Northwest asked for an exemption in late 2002, saying it did not have enough money to bring the funds up to required levels. But in the second quarter, the company posted its first quarterly profit in nearly two years. It also reported that cash reserves now stand at \$2.8 billion. Despite the stronger balance sheet, Northwest says it'll take advantage of the break to contribute at least \$223 million in Pinnacle Airlines stock to its pension plans and husband the cash stash for other uses.

CHARGES IN A BW STOCK-TIP CASE

FEDERAL AUTHORITIES HAVE charged a former U.S. Postal Service employee with securities fraud for misappropriating stock tips from *BusinessWeek*. On Aug. 20, the SEC sued Davi Thomas, formerly em-

ployed in a Mount Vernon (N.Y.) sorting facility, charging that he reaped \$154,000 by trading stocks mentioned in BW's Inside Wall Street column. From 1996 to 1999, Thomas allegedly read BW's column and passed through the facility and allegedly made numerous trades, profiting from what the SEC called the column's "material impact." The U.S. Attorney for the Eastern District of New York also filed an indictment. Thomas could not be located for comment. SEC officials say his whereabouts are unknown.

ET CETERA...

- Nokia sold more than 1% of its stake in ailing network outfit Redback Networks.
- Guidant must pay Johnson & Johnson \$425 million in patent infringement on a stent.
- The FCC allowed AOL to use video in its instant messaging service.



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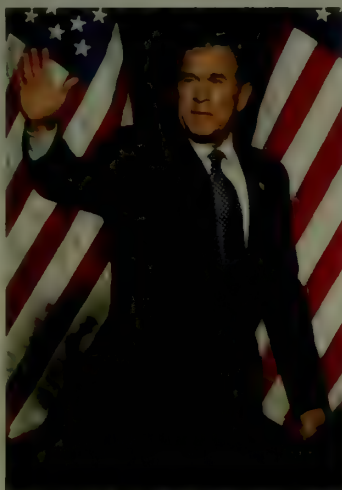
HOW THE BUSHIES WILL SPEND AN AVALANCHE OF CASH

Running for office isn't cheap. Senate campaigns in states such as North Carolina can set you back \$10 million, and a Presidential bid totals more than 10 times as much. By those expensive standards, President George W. Bush's ability to spend more than \$200 million between now and Labor Day 2004 would leave all previous records in the dust. With no GOP opposition, Bush can use the primary season to mount a lavish dress rehearsal. The Bush spending machine will try out new campaign technologies, soften up voters in key swing states, lay the groundwork for sophisticated get-out-the-vote efforts—and attempt to leave the Democrats in a futile game catch-up going into the general election. Of course, there will be TV time aplenty. In March, 2004, until the Republican convention in early September, the President's reelection campaign will blitz the airwaves. (The campaign has to burn through primary funds before the convention so it can qualify for public funds in the general election.)

It won't be just the quantity of Bush ads that will stand out. The campaign will have the resources to replace hackneyed 30-second spots with one- or even two-minute vignettes on local stations and cable. "The 30-second spot is less and less effective," says GOP pollster Frank I. Luntz. Longer pitches aren't cheap: Luntz says a 60-second spot costs 70% more than the standard half-minute. But the Bushies can afford it. Just as important will be where those commercials run. In Bush's war chest, he can hit hard in states he lost in 2000, including Iowa, Michigan, Pennsylvania, and Wisconsin. The campaign might also advertise in such likely Democratic states as New York, Illinois, and California, forcing Democrats to spend scarce dollars protecting turf. While Bush will spend plenty on media, he'll have lots of money over to put in place an ambitious get-out-the-vote effort—

denying Democrats that traditional edge. "We will be dedicating substantial resources to our grassroots network," says Scott Stanzel, spokesman for the Bush-Cheney campaign.

Bush's cash will also buy the best information about voters and their preferences, which in turn will allow the campaign to customize its message. "We've found that it's not always a good idea to reach out to people based on party affiliation but rather on issues that we agree on," says Blaize Hazelwood, political director of the Republican National Committee.



BUSH: High-tech campaign

New technology will let the Bushies nail down those connections more precisely than ever. Luntz points to automated polling systems that can call people, ascertain a respondent's positions on 10 key issues, and deliver a follow-up call emphasizing points where the President's agenda dovetails with the household's priorities. "In a sense, it will allow [Bush] to personalize the campaign even while it is national in scope," he says. All that cash could also make direct mail much more effective: Voters may find videos or CD-ROMs in their mailboxes instead of brochures.

With the Bush reelection effort equipped to spare no expense, Democrats are looking at a bleak picture. Emerging from a punishing primary fight, the nominee will immediately be pummeled on the airwaves—with little money left to respond. And Republicans will leverage sophisticated voter information to sway undecideds and insure a pro-Bush turnout on Election Day.

Some political analysts downplay the GOP's cash advantage. "I'd rather have a hot candidate with a hot message than all of the money in the world," says Phil Noble, founder of PoliticsOnline, a political-strategy firm specializing in Internet communications. That may be—but all the money in the world certainly won't hurt Bush.

By Alexandra Starr

CAPITAL WRAPUP

EXERCISE IN FUTILITY I

Florida Senator Bob Graham's Presidential campaign is playing a name game. It's citing moniker confusion for the increase in his negative poll ratings. Team Graham suggests South Carolina Democrats are mixing up Senator Bob with Republican Lindsey Graham, the state's junior senator. And in New Hampshire, aides say some voters are confusing Senator Bob with Republican Phil Gramm, a '96 White House hopeful. Graham is viewed favorably by 19% of Granite

State Dems vs. 29% unfavorable—up from 7% in January, according to American Research Group (ARG) polls. Only Al Sharpton does worse.

EXERCISE IN FUTILITY II

► North Carolina Senator John Edwards, also looking for more recognition in New Hampshire, took to the airwaves this summer. Now, 86% of voters are aware of his candidacy, according to ARG. But Edwards' positive ratings haven't budged, and support has dipped from 3% to 2%. Maybe it's better to be unknown than unloved.

THE ODDS ON ARNOLD

► Will Arnold Schwarzenegger be California's next governor? You can bet on it—and the odds are in his favor. Betonsports.com, one of the biggest gambling sites, has an Arnold win at 1-2. At BoDog.com, \$10 on Arnold nets only \$11. For a real payout, \$10 on comedian Gallagher promises a half-million at BetWWTS.com. Governor Gray Davis can take some consolation: At 4-1 on BoDog, his odds are better than the Republican he beat in '02, Bill Simon (5-1).



KARSAI PLASTICS IN HUNGARY: Cheap labor isn't enough anymore

EASTERN EUROPE

A CHILL WIND BLOWS FROM THE EAST

Eastern Europe's dynamos are losing jobs to Asia

At first glance, IBM's computer disk-drive factory in Szekesfeharvar, Hungary, doesn't look the picture of industrial decline. Built just eight years ago, its bright facade still glows from a hillside overlooking a bustling shopping plaza. But a closer look reveals an unnatural stillness. Loading docks that once were piled high with components lie empty. Turnstiles that admitted 3,700 workers a day are chained.

IBM shut the plant last November, moving the work to China, where wages are 75% cheaper. Dutch electronics maker Royal Philips Electronics and Singapore contract manufacturer Flextronics International Ltd. have moved an additional 1,500 Hungarian jobs to China in the past 18 months. Flextronics also has closed a 1,000-worker plant in the

Czech Republic. The closings are sending shudders across eight formerly communist countries just as they are gearing up to celebrate their entry into the European Union on May 1.

The most successful of that group—Hungary, Poland, and the Czech Republic—have been put on warning even before the party starts that EU membership is no economic panacea. The labor markets of Asia, especially China,

are beginning to jettison away industrial investments that helped this region rebuild after communism's collapse. "The whole goal has been to join the EU," says Humphrey W. Porter, president of Flextronics Europe. "The risk is that they don't realize this is a rat race. And it's just beginning, not the end."

The manufacturing flight is prompting some governments to look for ways to diversify their economies. "These countries have to make their minds where they want to be in 10 years' time," says Wim Wiele

Philips regional CEO for Europe. "If they try to keep attracting [investment based on] cheap labor, they'll have problems. Their real future test will be how well they emphasize knowledge-based jobs."

The competition will be harsh. India, the Philippines, and Russia are rising powers in information technology and customer support. But Eastern Europe has some advantages. EU law prohibits storage of banking data outside the union. So joining the EU will help the region grab back-office financial jobs. EU membership also will increase the feeling of security for foreign investors.

But Eastern Europe's cost advantage is shrinking by the day. In the past two years, real wages have risen by 20% in Hungary and 11.5% in the Czech Republic, according to Vienna-based ERM Bank. Despite the runup, wages in Eastern Europe's most dynamic economies are still 25% lower than those in Western Europe. But the gap is widening with China, where wages have stayed about \$100 per month for unskilled factory

Upgrading Eastern Europe

AS UNSKILLED MANUFACTURING JOBS MOVE TO CHINA . . .

COMPANY	JOBS	COUNTRY	DESTINATION	YEAR
IBM	3,700	Hungary	China	2002
FLEXTRONICS	1,000	Hungary	China	2002
PHILIPS	500	Hungary	China	2003

... EAST EUROPE SNAGS SOME GLOBAL SERVICE POSITIONS

COMPANY	JOBS	DESCRIPTION	DESTINATION	YEAR
GE	500	IT, back office	Hungary	2002
DIAGEO	300	Back office	Hungary	2002
EDS	140	Call center	Hungary	2002
PHILIPS	500	Back office	Poland	2003
IBM	200	Customer support	Czech Rep	2001
LogicaCMG	200	IT	Czech Rep	2003

Data: Companies, BusinessWeek

workers. Greater access to China's domestic market also makes the move for moving production more coming. Even Eastern European companies, such as Hungary's Karsai Plastics, are opening plants in China. Wages don't dictate every investment decision. Proximity to Western Europe, to mention Eastern Europe's blossoming consumer markets, can be an advantage. For large appliances or cars, shipping costs are high. PSA Peugeot-Citroën and Toyota Motor Corp. opened a joint plant in the Czech Republic in 2005 employing 3,000. PSA will open a 3,500-worker factory in 2006 in Slovakia. And since moving production, Microsoft Corp.'s Xbox game consoles to China, Flextronics has hired Hungarians to make goods such as for France's Schneider Electric. Thanks to such investment, the number of overall manufacturing jobs in Hungary and the Czech Republic has remained steady in 2001 and 2002, while the two economies are growing at 2.7% and 2.2%, respectively. But that's following years of heady manufacturing growth. And Poland has lost 250,000 manufacturing jobs in the same period. Some of the manufacturing work is being replaced by higher-skilled jobs. About three miles from IBM's mothered factory in Szekesfehervar, Alcoa just hired 210 service workers. Two-thirds of them handle finance and administration tasks. The rest, mostly young techies dressed in T-shirts and shorts, run and help design applications on a computer system that serves 100 Alcoa Inc. workstations across the continent. Plano (Tex.)-based Electric Data Systems Corp. has operations in Poland, Hungary, and the Czech Republic. Its call center in Budapest provides remote information technology support for companies such as General Motors, Coca-Cola, and Sweden's Ericsson. "There's going to be a huge change in the next three to five years in transition to commoditized back-office services," says Laszlo Szakal, EDS's chief sales executive for Hungary. To attract these jobs, governments in Eastern Europe are starting to re-up education systems that have been neglected since the political changes of 1989-90. In Hungary, a new law allows industry groups to supervise curriculum at vocational schools. "It's not enough anymore just to create a safe legal, financial, and economic environment," says Hungary's Economy & Transport Minister, Istvan Csillag. To keep pace in the global economic race, new EU members will have to use their heads more than their hands.

By Christopher Condon in Budapest, and Rick Butler in Warsaw

RUSSIA

RETAIL BANKING RENAISSANCE

Local and foreign banks are courting Russia's middle class

Russia has done a lot to nurture a consumer-oriented, free-market economy out of the ruins of communism. But one crucial gear of capitalism is still missing—a thriving network of private retail banks. State-run Sberbank still dominates the retail landscape as inroads by private banks were wiped out in the financial crisis of 1998—along with many Russians' savings.

Now that is finally changing. With Russia's economy clocking steady growth, private banks, both local and foreign, are making a big push to expand their retail business. Dozens of retail branches are opening around Moscow and other cities, featuring services not offered by Sberbank, such as 24-hour banking and unsecured personal loans. "The country has reached the point that we can develop a profitable business serving middle-class clients," says Didier Alix of France's Société Générale, which plans to open the first of five branches in Moscow this fall.

The expansion is timed to coincide with the expected passage in the next few months of a law that extends deposit insurance to private accounts. Deposits up to \$620 would be 100% guaranteed, while those up to \$3720 would be 75% secured. Until now only Sberbank accounts have been protected, which has helped it keep a lock on 68% of all retail deposits. But even without the new law, private bank deposits are growing. Total retail bank deposits have doubled since 2001 to \$40.1 billion. At the same time, Sberbank's market share has dropped from 75% in 2000, and brokerage Troika Dialog forecasts it falling to 63% by 2005. Russia's Alfa Bank, Rosbank, and MDM Bank all are expanding rapidly.



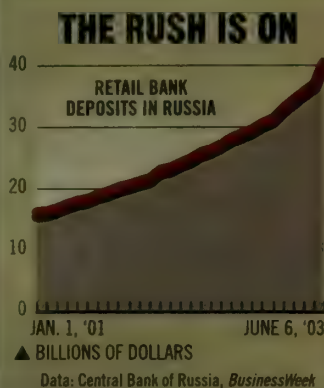
AGGRESSIVE: Alfa has the lead in private retail banking

Foreign banks are also wading into the market, including SG, the U.S.'s Citibank, and Austria's Raiffeisen Bank. They're offering new services to Russians, such as online banking. Raiffeisen boasts a six-branch network and has three more in the works. Citibank, the world's largest retail bank, opened its first branch in Moscow last December. "Only 33% of savings is estimated to be in the banking sector, so there's a huge opportunity to bring new customers to the industry," says Nandan Mer, head of Citibank's local retail unit.

Rising incomes and consumer demand have led to a surge in car loans and mortgages. Outstanding loans to retail clients hit \$6.45 billion in June, 2003, up from just \$1.02 billion in January, 2000, says Russia's central bank. It's a high-profit business for the banks. Average interest rates on ruble deposits are about 5%, while rates on retail loans average 20%.

The big challenge for newcomers is distribution, especially for foreign banks with fewer outlets. Citibank is relying on telephone, the Internet, ATMs, and alliances with local retailers. With memories of 1998 fading, now is the time to provide Russians with new ways to stash their cash.

By Jason Bush in Moscow, with Carol Matlack in Paris



TAIWAN

PC MAKERS: MORE SALES, FEWER PROFITS

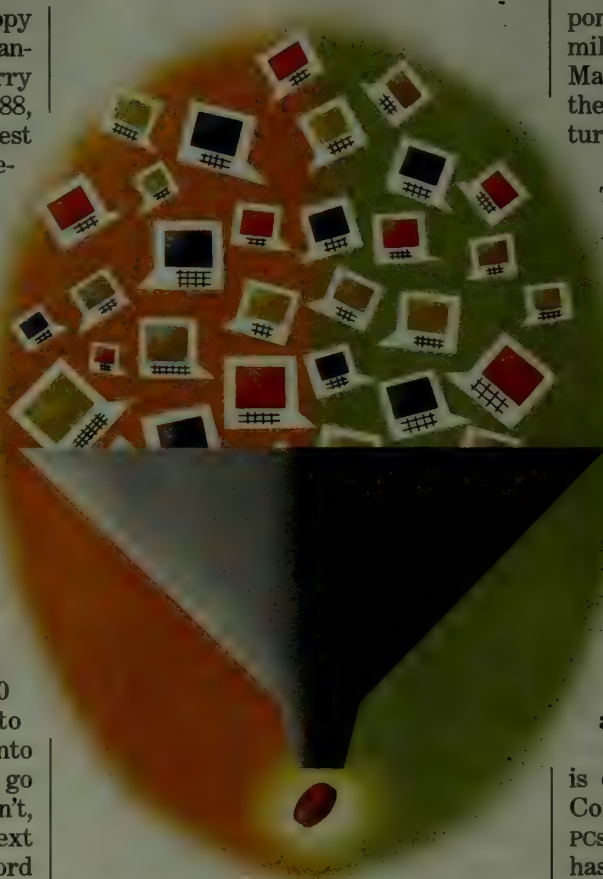
Some Taiwan manufacturers plan to switch to high-end TVs

If anybody in Taiwan should be happy with the computer business, it's Quanta Computer Inc. Chairman Barry Lam. Since he founded Quanta in 1988, it has become one of the world's biggest designers and manufacturers of notebook PCs. Quanta makes one-quarter of all notebooks sold in the world and counts Dell and Hewlett-Packard among its major customers. And in this year's second quarter, Quanta's sales nearly doubled.

So why isn't Lam crowing? Because it's getting tougher to make big profits. In two years, Quanta's gross margins have shrunk from 15% to just 5% as notebook PCs have started to become low-cost commodities. Taiwan Ratings Corp., an affiliate of Standard & Poor's in Taipei, predicts that Quanta's profits this year will be up no more than 10%, to \$350 million, even as sales jump 70%, to \$7.1 billion. So Lam is diversifying into servers and digital TVs. "We have to go beyond the PC," says Lam. "If we don't, our margins will keep dropping." Next year, Lam even plans to cut the word "computer" from the company's name.

Other Taiwanese computer makers are at the same crossroads. In this year's first half, Taiwan's notebook shipments jumped 23%, to 10.7 million units, thanks to more outsourcing by top U.S. and Japanese brands. But the average price manufacturers get fell 10%, to \$666, says IT researcher Market Information Center in Taiwan. Relentless price deflation has long been a fact of life in electronics. But the downward spiral has accelerated. In the first quarter, Lite-On Electronics Inc. says selling prices for its color monitors, keyboards, and other PC products dropped by up to 20%, double last year's pace. "It's a micro-profit era," says Lite-On CEO David Lin.

Helping drive profits down is the industry's still-weak pricing power and PC industry consolidation. Second-tier players such as Gateway and NEC are losing share. And last year, Hewlett-



Packard Co. swallowed Compaq Computer Corp. Now, Dell Inc. and HP control 50.1% of the U.S. PC market. So the Big Two have more leverage to squeeze contractors. "There's been a landscape shift," says Morgan Stanley tech investment banker Julian Snelder. "That puts tremendous pressure on suppliers."

To compensate, some PC contract manufacturers are launching their own

brands. Others, such as Quanta and MITAC International Corp., are scrambling to diversify. Digital TVs are a particularly intriguing post-PC option. Midmarket televisions are still assembled by the companies whose brands appear on them, such as Panasonic, Sony, and Samsung. But because many key parts also are used in PCs, the Taiwanese see TVs as a natural for them. "All the components of digital TV will be very familiar to us," says MITAC Chairman Matthew F.C. Miao. "It may be that the IT people will be the ones manufacturing TVs."

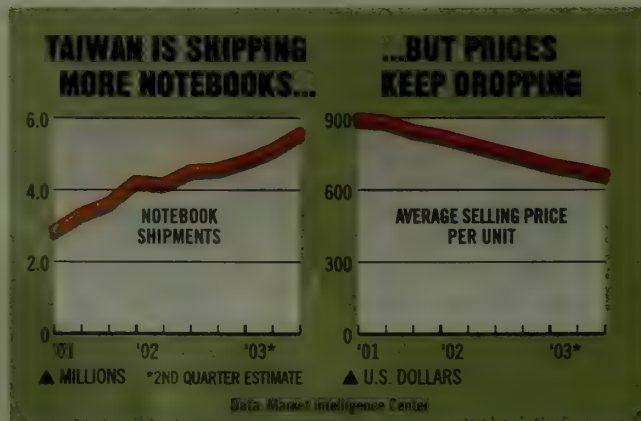
The Taiwanese hope to either make TVs for major consumer electronics companies or for PC companies looking to enter new markets. Quanta's Lam thinks computer makers will do well because they're used to cutthroat competition. Later this year, Quanta will start producing 23-inch and 26-inch digital TVs that will retail for up to \$1,500, for a brand he won't name. Lam predicts that Quanta's dependence on notebook PCs will drop from 95% of sales in 2002 to 50% four years from now. Still, the Taiwanese have little experience in high-end consumer electronics. And competition from Chinese producers is likely to be fiercer at the low end.

Entering the brand-name business is even riskier. For example, ASUS Computer Inc., a maker of notebook PCs, game consoles, and motherboards, has launched a handheld PC under the MyPal name. Inventec Corp., another notebook producer, sells cell phones and PDAs under the name OKWAP.

Taiwan's electronics industry tried this tactic in the 1980s and 1990s—with mixed results. MITAC ended up dropping its brand. Acer enjoyed some success in the U.S. but couldn't match the marketing and distribution of American rivals. The brand business is "a totally different culture" from contract manufacturing, warns Acer Chairman Stan Shih. Can other Taiwanese companies succeed where Acer failed? "No way," he scoffs.

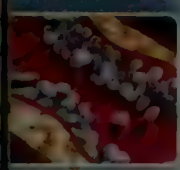
Some PC makers say they've learned from Acer's frustration and are sticking to Asian markets. In June, MITAC started selling its Mio brand smart phones only in Taiwan. "Dell's not in the phone business, and HP's not in the phone business," says Miao. For now, that's reason enough to test uncharted waters.

By Bruce Einhorn in Taipei



Are you one of the millions of Americans
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PLAVIX[®], added to aspirin and your current
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IMPORTANT INFORMATION: If you have a medical condition that causes bleeding, such as stomach ulcer,
you should not use PLAVIX. The risk of bleeding may increase with PLAVIX, and when you take PLAVIX
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risk. Additional rare, but serious, side effects could occur.

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PLAVIX®

clopidogrel bisulfate tablets

BRIEF SUMMARY— Please see package insert for full prescribing information.

INDICATIONS AND USAGE: PLAVIX (clopidogrel bisulfate) is indicated for the reduction of thrombotic events as follows:

Recent MI, Recent Stroke or Established Peripheral Arterial Disease

For patients with a history of recent myocardial infarction (MI), recent stroke, or established peripheral arterial disease, PLAVIX has been shown to reduce the rate of a combined endpoint of new ischemic stroke (fatal or nonfatal), new MI (fatal or nonfatal), and other vascular death.

Acute Coronary Syndrome

For patients with acute coronary syndrome (unstable angina/non-Q-wave MI) including patients who are to be managed medically and those who are to be managed with percutaneous coronary intervention (with or without stent) or CABG, PLAVIX has been shown to decrease the rate of a combined endpoint of cardiovascular death, MI, or stroke as well as the rate of a combined endpoint of cardiovascular death, MI, stroke, or refractory angina.

CONTRAINDICATIONS: The use of PLAVIX is contraindicated in patients with a hypersensitivity to the drug substance or any component of the product, and those with active pathological bleeding such as peptic ulcer or intracranial hemorrhage.

WARNINGS: Thrombotic thrombocytopenic purpura (TTP). TTP has been reported rarely following use of PLAVIX, sometimes after a short exposure (<2 weeks). TTP is a serious condition requiring prompt treatment. It is characterized by thrombocytopenia, microangiopathic hemolytic anemia (schistocytes) (fragmented RBCs) seen on peripheral smear, neurological findings, renal dysfunction, and fever. TTP was reported in clopidogrel clinical trials, which included over 17,500 clopidogrel-treated patients. In world-wide postmarketing experience, however, TTP has been reported at a rate of about four cases per million patients exposed or about 11 cases per million patient-years. The background rate is thought to be about four cases per million patient-years.

PRECAUTIONS: General: As with other antiplatelet agents, PLAVIX prolongs the bleeding time and therefore should be used with caution in patients who may be at risk of increased bleeding from trauma, surgery, or other pathological conditions (particularly gastrointestinal and intracranial). If a patient is to undergo elective surgery and an antiplatelet effect is not desired, PLAVIX should be discontinued 5 days prior to surgery. Due to the risk of bleeding and undesirable hematological effects, blood cell count determination and/or other appropriate testing should be promptly considered, whenever such suspected clinical symptoms arise during the course of treatment (see ADVERSE REACTIONS). GI Bleeding: In CAPRIE, PLAVIX was associated with a rate of gastrointestinal bleeding of 2.0% vs 2.7% on aspirin. In CURE, the incidence of major gastrointestinal bleeding was 1.3% vs 0.7% (PLAVIX + aspirin vs placebo + aspirin, respectively). PLAVIX should be used with caution in patients who have lesions with a propensity to bleed (such as ulcers). Drugs that might induce such lesions should be used with caution in patients taking PLAVIX. Use in Hepatically Impaired Patients: Experience is limited in patients with severe hepatic disease who may have bleeding diatheses. PLAVIX should be used with caution in the population. Use in Renally Impaired Patients: Experience is limited in patients with severe renal impairment. PLAVIX should be used with caution in this population.

Information for Patients: Patients should be told that it may take them longer than usual to stop bleeding when they take PLAVIX, and that they should report any unusual bleeding to their physician. Patients should inform physicians and dentists that they are taking PLAVIX before any surgery is scheduled and before any new drug is taken.

Drug Interactions: Study of specific drug interactions yielded the following results. Aspirin: Aspirin did not modify the clopidogrel-mediated inhibition of ADP-induced platelet aggregation. Concomitant administration of 500 mg of aspirin twice a day for 1 day did not significantly increase the prolongation of bleeding time induced by PLAVIX. PLAVIX potentiated the effect of aspirin on collagen-induced platelet aggregation. PLAVIX and aspirin have been administered together for up to one year. Heparin: In a study in healthy volunteers, PLAVIX did not necessitate modification of the heparin dose or alter the effect of heparin on coagulation. Coadministration of heparin had no effect on inhibition of platelet aggregation induced by PLAVIX. Nonsteroidal Anti-inflammatory Drugs (NSAIDs): In healthy volunteers receiving naproxen, concomitant administration of PLAVIX was associated with increased occult gastrointestinal blood loss. NSAIDs and PLAVIX should be coadministered with caution. Warfarin: The safety of the coadministration of PLAVIX with warfarin has not been established. Consequently, concomitant administration of these two agents should be undertaken with caution. (See Precautions-General.) Other Concomitant Therapy: No clinically significant pharmacodynamic interactions were observed when PLAVIX was coadministered with atenolol, nifedipine, or both atenolol and nifedipine. The pharmacodynamic activity of PLAVIX was also not significantly influenced by the coadministration of phenobarbital, cimetidine, or estrogen. The pharmacokinetics of digoxin or theophylline were not modified by the coadministration of PLAVIX (clopidogrel bisulfate). At high concentrations *in vitro*, clopidogrel inhibits P-glycoprotein (P-gp). Accordingly, PLAVIX may interfere with the metabolism of phenytoin, lamotrigine, lisdexamfetamine, warfarin, lorazepam, fentanyl, and many non-steroidal anti-inflammatory agents, but there are no data with which to predict the magnitude of these interactions. Caution should be used when any of these drugs is coadministered with PLAVIX. In addition to the above specific interaction studies, patients entered into clinical trials with PLAVIX received a variety of concomitant medications including diuretics, beta-blocking agents, angiotensin converting enzyme inhibitors, calcium antagonists, cholesterol lowering agents, coronary vasodilators, antidiabetic agents (including insulin), antiepileptic agents, hormone replacement therapy, heparins (unfractionated and LMWH), and GPIIb/IIIa antagonists without evidence of clinically significant adverse interactions. The use of oral anticoagulants, non-study anti-platelet drug and chronic NSAIDs was not allowed in CURE and there are no data on their concomitant use with clopidogrel.

Drug/Laboratory Test Interactions: None known.

Carcinogenesis, Mutagenesis, Impairment of Fertility: There was no evidence of tumorigenicity when clopidogrel was administered for 78 weeks to mice and 104 weeks to rats at dosages up to 77 mg/kg per day, which afforded plasma exposures >25 times that in humans at the recommended daily dose of 75 mg. Clopidogrel was not genotoxic in four *in vitro* tests (Ames test, DNA-repair test in rat hepatocytes, gene mutation assay in Chinese hamster fibroblasts, and metaphase chromosome analysis of human lymphocytes) and in one *in vivo* test (micronucleus test by oral route in mice). Clopidogrel was found to have no effect on fertility of male and female rats at oral doses up to 400 mg/kg per day (52 times the recommended human dose on a mg/m² basis).

Pregnancy: Pregnancy Category B. Reproduction studies performed in rats and rabbits at doses up to 500 and 300 mg/kg/day (respectively, 65 and 78 times the recommended daily human dose on a mg/m² basis), revealed no evidence of impaired fertility or fetotoxicity due to clopidogrel. There are, however, no adequate and well-controlled studies in pregnant women. Because animal reproduction studies are not always predictive of a human response, PLAVIX should be used during pregnancy only if clearly needed.

Nursing Mothers: Studies in rats have shown that clopidogrel and/or its metabolites are excreted in the milk. It is not known whether this drug is excreted in human milk. Because many drugs are excreted in human milk and because of the potential for serious adverse reactions in nursing infants, a decision should be made whether to discontinue nursing or to discontinue the drug, taking into account the importance of the drug to the nursing woman.

Pediatric Use: Safety and effectiveness in the pediatric population have not been established.

ADVERSE REACTIONS: PLAVIX has been evaluated for safety in more than 17,500 patients, including over 9,000 patients treated for 1 year or more. The overall tolerability of PLAVIX in CAPRIE was similar to that of aspirin regardless of age, gender and race, with an approximately equal incidence (13%) of patients withdrawing from treatment because of adverse reactions. The clinically important adverse events observed in CAPRIE and CURE are discussed below.

Hemorrhage: In CAPRIE patients receiving PLAVIX, gastrointestinal hemorrhage occurred at a rate of 2.0%, and required hospitalization in 0.7%. In patients receiving aspirin, the corresponding rates were 2.7% and 1.1%, respectively. The incidence of intracranial hemorrhage was 0.4% for PLAVIX compared to 0.5% for aspirin.

In CURE, PLAVIX use with aspirin was associated with an increase in bleeding compared to placebo with aspirin (see Table 3). There was an excess in major bleeding in patients receiving PLAVIX plus aspirin compared to placebo plus aspirin, primarily gastrointestinal and at puncture sites. The incidence of intracranial hemorrhage (0.1%), and fatal bleeding (0.2%), was the same in both groups.

In patients receiving both PLAVIX and aspirin in CURE, the incidence of bleeding is described below.

CURE incidence of bleeding complications (% patients)				
Event	PLAVIX (+ aspirin) [*] (n=6259)	Placebo (+ aspirin) [*] (n=6303)	P-value	
Major bleeding [†]	3.7 [‡]	2.7 [‡]	0.001	
Life-threatening bleeding	2.2	1.8	0.13	
Fatal	0.2	0.2		
5 g/dL hemoglobin drop	0.9	0.9		
Requiring surgical intervention	0.7	0.7		
Hemorrhagic strokes	0.1	0.1		
Requiring intubation	0.5	0.5		
Requiring transfusion (≥4 units)	1.2	1.0		
Other major bleeding	1.6	1.3	0.005	
Significantly disabling	0.4	0.3		
Intracranial bleeding with significant loss of vision	0.1	0.1		
Requiring ≥3 units of blood	1.3	0.9		
Minor bleeding [§]	5.1	2.4	<0.001	

^{*} Other standard therapies were used as appropriate.

[†] Life threatening and other major bleeding.

[‡] Major bleeding event rate for PLAVIX + aspirin was dose-dependent on aspirin: <100 mg=2.6%, 100-200 mg=3.5%, >200 mg=4.9%.

[§] Major bleeding event rate for placebo + aspirin was dose-dependent on aspirin: <100 mg=2.0%, 100-200 mg=2.3%, >200 mg=4.0%.

^{||} Led to interruption of study medication.

Ninety-two percent (92%) of the patients in the CURE study received heparin/LMWH and the rate of bleeding in these patients was similar to the overall result.

There was no excess in major bleeds within seven days after coronary bypass graft surgery in patients who stopped therapy more than five days prior to surgery (event rate 4.4% PLAVIX + aspirin; 5.3% placebo + aspirin). In patients who remained on therapy within five days of bypass graft surgery, the event rate was 9.6% for PLAVIX + aspirin, and 6.3% for placebo + aspirin.

Neutropenia/agranulocytosis: Ticlopidine, a drug chemically similar to PLAVIX, is associated with a 0.8% rate of severe neutropenia (less than 450 neutrophils/mm³). In CAPRIE severe neutropenia was observed in six patients, four on PLAVIX and two on aspirin. Two of the 9599 patients who received PLAVIX and none of the 9586 patients who received aspirin had neutrophil counts of zero. One of the four PLAVIX patients in CAPRIE was receiving cytarabine chemotherapy, and another recovered and returned to the trial after only temporarily interrupting treatment with PLAVIX (clopidogrel bisulfate). In CURE, the numbers of patients with thrombocytopenia (19 PLAVIX + aspirin vs 24 placebo + aspirin) or neutropenia (13 vs 3) were similar.

Although the risk of myelotoxicity with PLAVIX thus appears to be quite low, this possibility should be considered when a patient receiving PLAVIX demonstrates fever or other sign of infection.

Gastrointestinal: Overall, the incidence of gastrointestinal events (e.g. abdominal pain, dyspepsia, gastritis and constipation) in patients receiving PLAVIX (clopidogrel bisulfate) was 27.1%, compared to 29.6% in those receiving aspirin in the CAPRIE trial. In the CURE trial the

incidence of these gastrointestinal events for patients receiving PLAVIX + aspirin was 11.7% compared to 12.5% for those receiving aspirin.

In the CAPRIE trial, the incidence of peptic, gastric or duodenal ulcers was 0.7% for PLAVIX and 1.2% for aspirin. In the CURE trial the incidence of peptic, gastric or duodenal ulcers was 0.4% for PLAVIX + aspirin and 0.3% for placebo + aspirin.

Cases of diarrhea were reported in the CAPRIE trial in 4.5% of patients in the PLAVIX group compared to 3.4% in the aspirin group. However, these were rarely severe (PLAVIX=0.2% and aspirin=0.1%). In the CURE trial, the incidence of diarrhea for patients receiving PLAVIX + aspirin was compared to 2.2% for those receiving placebo + aspirin.

In the CAPRIE trial, the incidence of patients withdrawing from treatment because of gastrointestinal adverse reactions was 3.1% for PLAVIX and 4.0% for aspirin. In the CURE trial, the incidence of patients withdrawing from treatment because of gastrointestinal adverse reactions was 0.9% for PLAVIX + aspirin compared with 0.8% for placebo + aspirin.

Rash and Other Skin Disorders: In the CAPRIE trial, the incidence of skin and appendage disorders in patients receiving PLAVIX was (0.7% versus); the corresponding rate in aspirin patients was 1.3% (0.5% versus). In the CURE trial the incidence of rash or other skin disorders in patients receiving PLAVIX + aspirin was 4.0% compared to 3.5% for those receiving placebo + aspirin.

In the CAPRIE trial, the overall incidence of patients withdrawing from treatment because of skin and appendage disorders adverse reactions was 1.5% for PLAVIX and 0.8% for aspirin. In the CURE trial, the incidence of patients withdrawing because of skin and appendage disorders adverse reactions was 0.7% for PLAVIX + aspirin compared with 0.3% for placebo + aspirin.

Adverse events occurring in ≥2% of patients on PLAVIX in the CAPRIE controlled clinical trial are shown below regardless of relationship to PLAVIX. The median duration of therapy was 20 months, with a maximum of 3 years.

Adverse Events Occurring in ≥2% of PLAVIX Patients in CAPRIE				
Body System	PLAVIX (n=9599)	% Incidence (% Discontinuation)	Aspirin (n=9586)	% Incidence (% Discontinuation)
Body as a Whole—general disorders				
Allergic reaction	8.1	(0.2)	8.3	(0.1)
Accidental/infectious injury	7.9	(0.1)	7.3	(0.1)
Influenza-like symptoms	7.5	(<0.1)	7.0	(<0.1)
Pain	6.4	(0.1)	6.3	(0.1)
Fatigue	3.3	(0.1)	3.4	(0.1)
Cardiovascular disorders, general				
Hypertension	4.1	(<0.1)	4.5	(<0.1)
Hypotension	4.3	(<0.1)	5.1	(<0.1)
Central & peripheral nervous system disorders				
Headache	7.6	(0.3)	7.2	(0.2)
Dizziness	8.1	(0.2)	6.7	(0.3)
Gastrointestinal system disorders				
Abdominal pain	8.8	(0.7)	7.1	(1.0)
Dyspepsia	5.2	(0.4)	5.1	(0.7)
Diarrhea	4.5	(0.4)	3.4	(0.4)
Nausea	3.4	(0.1)	3.3	(0.4)
Metabolic & nutritional disorders				
Hyperkalemia	4.0	(0)	4.4	(<0.1)
Musculoskeletal system disorders				
Arthralgia	6.3	(0.1)	6.2	(0.1)
Back pain	8.8	(0.1)	5.3	(<0.1)
Platelet, bleeding, & clotting disorders				
Purpura/bruise	5.3	(0.3)	3.7	(0.1)
Ectopic	8.8	(0.2)	2.5	(0.1)
Psychiatric disorders				
Depression	3.3	(0.1)	3.9	(0.2)
Respiratory system disorders				
Upper resp tract infection	8.7	(<0.1)	8.1	(<0.1)
Dyspnea	4.5	(0.1)	4.7	(0.1)
Rhinitis	4.2	(0.1)	3.8	(0.1)
Bronchitis	3.7	(0.1)	3.7	(0.1)
Coughing	3.1	(<0.1)	2.7	(<0.1)
Skin & appendage disorders				
Rash	4.2	(0.5)	3.5	(0.3)
Pruritus	3.3	(0.3)	1.6	(0.1)
Urinary system disorders				
Urinary tract infection	3.1	(0.1)	3.3	(0.1)

Incidence of discontinuation, regardless of relationship to therapy, is shown in parentheses.

Adverse events occurring in ≥2.0% of patients on PLAVIX in the CURE controlled clinical trial are shown below regardless of relationship to PLAVIX.

Adverse Events Occurring in ≥2.0% of PLAVIX Patients in CURE				
Body System	PLAVIX (+ aspirin) [*] (n=6259)	% Incidence (% Discontinuation)	Placebo (+ aspirin) [*] (n=6303)	% Incidence (% Discontinuation)
Body as a Whole—general disorders				
Chest Pain	2.7	(<0.1)	2.8	(0.0)
Central & peripheral nervous system disorders				
Headache	3.1	(0.1)	3.2	(0.1)
Dizziness	2.4	(0.1)	2.0	(<0.1)
Gastrointestinal system disorders				
Abdominal pain	2.3	(0.3)	2.8	(0.3)
Dyspepsia	2.0	(0.1)	1.9	(<0.1)
Diarrhea	2.1	(0.1)	2.2	(0.1)

^{*} Other standard therapies were used as appropriate.

Other adverse experiences of potential importance occurring in 1% to 2.5% of patients receiving PLAVIX (clopidogrel bisulfate) in CAPRIE or CURE controlled clinical trials are listed below regardless of relationship to PLAVIX. In general, the incidence of these events is similar to that in patients receiving aspirin in CAPRIE or placebo + aspirin in CURE.

Autonomic Nervous System Disorders: Syncope. **Palpitation:** Body as a Whole—general disorders: Asthenia, Fever, Herpes, Cardiovascular disorders: Cardiac failure, Central and peripheral nervous system disorders: Cramps, legs; Hypoaesthesia, Neuralgia, Paraesthesia, Vertigo. **Gastrointestinal system disorders:** Constipation, Vomiting, Heart rate and rhythm disorders: Fibrillation atrial, Liver and biliary system disorders: Hepatic enzymes increased. **Metabolic and nutritional disorders:** Gout, hypernatremia, non-protein nitrogen (NPN) increased. **Musculoskeletal system disorders:** Arthritis, Arthralgia, Platelet bleeding & clotting disorders: GI hemorrhage, hematoma, platelets decreased. **Psychiatric disorders:** Anxiety, Insomnia. **Rash blood cell disorders:** Anemia. **Respiratory system disorders:** Pneumonia, Sinusitis. **Skin appendage disorders:** Eczema, Skin ulceration. **Urinary system disorders:** Cystitis, Vision disorders: Cataract, Conjunctivitis. Other potentially serious adverse events which may be of clinical interest but were rarely reported (<1%) in patients who received PLAVIX in the CAPRIE or CURE controlled clinical trials are listed below regardless of relationship to PLAVIX. In general, the incidence of these events was similar to that in patients receiving aspirin (in CAPRIE) or placebo + aspirin (in CURE). **Body as a whole:** Allergic reaction, necrotic. **Cardiovascular disorders:** Edema generalized. **Gastrointestinal system disorders:** Gastric ulcer perforated, gastritis hemorrhagic, upper GI ulcer hemorrhagic. **Liver and biliary system disorders:** Bilirubinemia, hepatitis infectious, liver fatty. **Platelet bleeding and clotting disorders:** hemarthrosis, hematuria, hemophysis, hemorrhage intracranial, hemorrhage retroperitoneal, hemorrhage of operative wound, liver hemorrhage, pulmonary hemorrhage, purpura allergic, thrombocytopenia. **Rash blood cell disorders:** Anemia aplastic, anemia hypochromic. **Reproductive disorders, female:** Menorrhagia. **Respiratory system disorders:** Hemothorax. **Skin and appendage disorders:** Bullous eruptions, erythematous, rash maculopapular, urticaria. **Urinary system disorders:** Abnormal renal function, acute renal failure, white cell and leukoedema. **Systemic disorders:** Agranulocytosis, granulocytopenia, leukemia leukopenia, neutrophils decreased.

Postmarketing Experience: The following events have been reported spontaneously from worldwide postmarketing experience: Body as a whole: hypersensitivity reactions, anaphylactic reactions. Central and Peripheral Nervous System disorders: confusion, hallucinations, disorders. Liver and biliary system disorders: abnormal liver function test: hepatitis (non-infectious). Platelet Bleeding and Clotting disorders: bleeding with fatal outcome (especially intracranial, gastrointestinal and retroperitoneal hemorrhage), agranulocytosis, aplastic myelopathy, thrombotic thrombocytopenic purpura (TTP) (see WARNINGS, conjunctival, ocular and retinal bleeding. Respiratory system disorders: bronchospasm. Skin and Appendage disorders: angioedema, erythema multiforme. Urinary system disorders: glomerulonephritis, abnormal creatinine levels.

OVERDOSSAGE: One case of deliberate overdosage with PLAVIX was reported in the large, CAPRIE controlled clinical study. A 34-year-old woman took a single 1,050-mg dose of PLAVIX (equivalent to 14 standard 75-mg tablets). There were no associated adverse events. No clinical therapy was instituted, and she recovered without sequelae. No adverse events were reported after single oral administration of 60 (equivalent to 8 standard 75-mg tablets) of PLAVIX in healthy volunteers. The bleeding time was prolonged by a factor of 1.7, which is larger than that typically observed with the therapeutic dose of 75 mg of PLAVIX per day. A single oral dose of clopidogrel at 1500 or 2000 mg was lethal to mice and to rats at 3000 mg/kg to baboons. Symptoms of acute toxicity were vomiting (in baboons), prostration, difficulty breathing, and gastrointestinal hemorrhage in all species.

Recommendations About Specific Treatment: Based on biological plausibility, platelet transfusion may be appropriate to reverse the macrological effects of PLAVIX if quick reversal is required.

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Revised May

ROSE BRADY

WILL THE ATTACK ON THE U.N. BACKFIRE ON THE BOMBERS?

was the most brazen attack against a U.N. mission ever. But the bombing of the U.N. headquarters in Baghdad on Aug. 19, which killed U.N. envoy Sergio Vieira de Mello and at least 20 others, may have an effect quite contrary to one intended. Rather than spurring the U.N. to close its military operations, the bombing could lead to the creation of a broader international peacekeeping coalition.

How to create such a coalition has divided the U.S. and a handful of key potential partners, from France to Pakistan, for weeks. With its military force of 139,000 stretched to the limit and unable to prevent recent attacks on oil and water pipelines, the U.S. urgently wants more countries to provide troops to assist in stabilizing Iraq. But France and India, able to send upwards of 10,000 soldiers each, have refused to participate without a U.N. Security Council mandate. Pakistan and Turkey are also reluctant to take part without a U.N. imprimatur. After its failed effort to win U.N. backing for the war, the Bush Administration has been wary about entering the diplomatic lion's den again.

But the upsurge in violence, topped off by the U.N. bombing, may change that political calculus. "This tragedy will shift the thinking in Washington in the direction reality has already been driving it—to bring the international community in, in a broader and deeper way," predicts Nancy Soderberg, a former U.S. ambassador to the U.N. Adds Anthony H. Cordesman, a Middle East expert at Washington's Center for Strategic & International Studies: "It may be easier for the U.S. to accept the [U.N.'s] value when people have made this kind of sacrifice. And it may be easier for countries to agree to a U.N. resolution."

The U.S., he notes, is slowly realizing that it is engaged in nation-building. "That requires more security personnel with the political and language skills needed to win hearts

and minds. Training an Iraqi security force should help. It would also be a plus if Islamic countries such as Pakistan or Iraq's Arab neighbors take part in peacekeeping. So far, the Arab League refuses to recognize the U.S.-appointed Iraqi Governing Council. Pakistan would send troops if there's an international mandate or a request from the Iraqis. "Our people must be convinced we are going in to help Iraqi people," says Pakistan's U.N. ambassador, Munir Akram.

The solution could resemble the Afghan model. There, the U.S. military continues its search for al Qaeda members, but international peacekeepers, now led by NATO, are stationed in Kabul. For Washington, the key is ensuring that Civil Administrator L. Paul Bremer III retains his authority. "You cannot ask him to take this on, then undercut him as soon as he gets up to speed," says a Pentagon official.

Whatever the U.S. and other Security Council members decide, the Iraqi transition will remain tough—and expensive. The pipeline attacks have dashed hopes that oil exports of 2 million barrels per day will resume by yearend. The U.S., which is paying \$4 billion a month for its military effort and rapidly spending \$3.6 billion in reconstruction funds allocated by Congress, is looking forward to a donors' conference on Iraq in October. How much other countries stump up could well depend on whether the U.S. allows a U.N.-authorized peace force. If terrorist attacks continue, Washington's incentive to spread the responsibility for nation-building will increase by the day.

With Stan Crock in Washington and bureau reports



BLAST SITE: *Galvanizing?*

BusinessWeek online

For an interview with Middle East expert Anthony H. Cordesman, go to www.businessweek.com/magazine/extra.htm

GLOBAL WRAPUP

RESHUFFLE IN PARIS?

France's center-right government is the hot seat for the way it handled the unprecedented mid-August heat wave, which claimed as many as 10,000 lives. As a result, President Jacques Chirac may move forward plans for a cabinet reshuffle that could even see the departure of controversial Foreign Minister Dominique de Villepin and Finance Minister Francis Mer.

The crisis has already claimed its latest victim with the Aug. 18 resignation of France's top medical official,

Lucien Abenham, and Health Minister Jean-François Mattei is likely to be next. A shortage of hospital beds and lack of air-conditioning in retirement homes exacerbated the effects of the 10-day heat wave. Many claim that the government should have moved much more quickly to proclaim a public health emergency.

Instead, Paris fumbled from the start. While France sizzled in 100-degree heat, almost all government ministers were on vacation. Prime Minister Jean-Pierre Raffarin only called his team back to the capital for an emer-

gency meeting on Aug. 14, three days after the heat peaked. Even Chirac is on the defensive for being on vacation in Canada during the heat wave.

The crisis comes at a bad time for the 15-month-old Raffarin government. It has been pulling back from promised economic reforms and badly handled a performing artists' strike that closed down many of France's famous summer music and theater festivals. Chirac is said to think a Cabinet reshuffle may improve the government's declining popularity.

By Christina Passariello in Paris

CHINA'S DREAM TEAM

Industrial designers are making a mark

Sun Yunbo never dreamed he might one day design cars. In fact, the farm boy from China's Jilin Province didn't even ride in an automobile until age 19. So the notion that his creations might someday roll off an assembly line was "absolutely unimaginable," Sun says. "A car was a mysterious thing." Today, though, Sun is one of 21 Chinese designers working on the Buick Excelle, a new sedan that General Motors Corp. plans to start selling in China this fall. "Now auto design is natural for me," Sun says.

Sun is at the vanguard of a trend that's shaking the world of design. As China grew into an export powerhouse over the past decade, most of what its factories churned out was designed elsewhere. Now, like the Japanese in the 1970s and the Koreans in the 1990s,

MOTOROLA PHONE: Shaped in Beijing



Chinese companies are keen to reap the higher margins and market share that often reward flashy, well-designed products. "Our goal is the transition from 'Made in China' to 'Designed in China,'" says He Renke, chairman of the industrial design department at Hunan University.

That's a big change from a decade ago, when industrial design was virtually unheard of in China. Today the country boasts some 200 design schools that churn out as many as 8,000 graduates a year.

Hundreds more top Chinese students are flocking to the best U.S. and European graduate programs in design. "The students are blazingly smart," says Patrick Whitney, director of the Illinois Institute of Technology's design school, which has a cooperative program with Tsinghua University's Academy of Arts & Design in Beijing.

GM helped get the movement rolling back in 1997. Together with its manufacturing partner, Shanghai Automotive Industry Corp., the carmaker established the design center in Shanghai, where Sun works. Since then, Siemens Mobile, LG Electronics, and Electrolux have used young local designers to create products tailored to China's

BLACK & DECKER IRON: Exported to U.S.



domestic market. "It really blows my mind how ded-



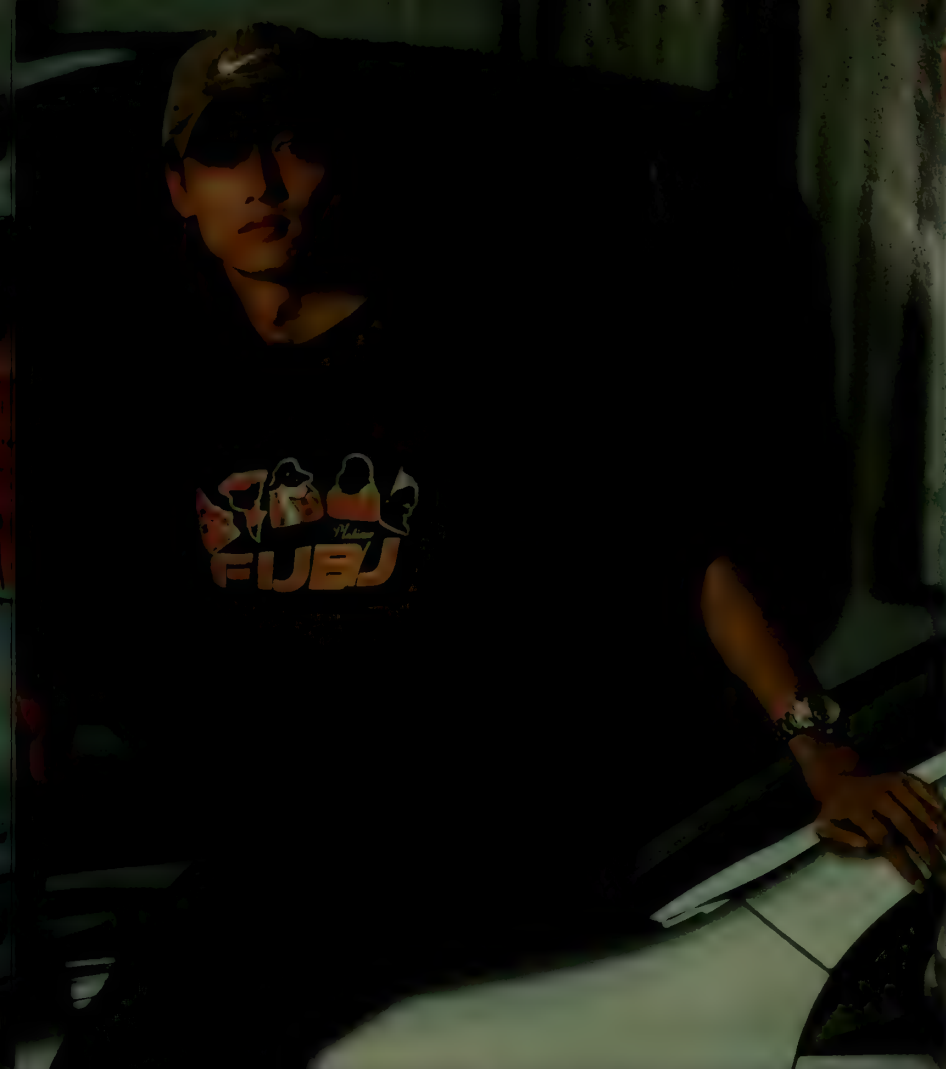
YOUNG AND RESTLESS Car des

icated they are," says Tim Parsey, rector of consumer-experience design for Motorola Inc.'s Personal Communications Div., which has seven designers in Beijing working on mobile phones aimed at the Chinese market.

Even so, it may be a while before designers in Milan, London, or Detroit need to worry about finding a new source of work. So far, most Chinese designers have simply tweaked color and form on export products, while conceptual work on new cars, appliances, and electronic gadgets is done in Europe or the U.S. "They have good designers, but they don't know the U.S. market" in many products, says Jerry W. Edwards, executive vice-president for merchandising at retailer Home Depot Inc., which hires Chinese subcontractors to produce items such as faucets and ceiling fans.

Despite the growing numbers of design schools in China, some wonder whether China's education system ultimately will be able to churn out world-class designers in quantity. China's Confucian emphasis on learning by rote stifles creative thinking and makes te-

Not long ago, industrial design was virtually unheard of. Now



...d Fang work out of GM's design center in Shanghai

...members reluctant to speak out, says
...you Yi, a former teacher of industrial
...design at Shanghai's Tongji University
...who now heads S.Point, an independ-
...ent firm that employs 17 designers and
...engineers doing work for the likes of
...emens Mobile, Electrolux, and Intel.
...t brainstorming sessions, they just
...there," says Zhou. "Even though
...y are thinking and have ideas, they
...t say anything."

Yet for products aimed at increasing-
...sophisticated consumers on the main-
...land, it's hard to beat Chinese designers.
...ne was, anything foreign could be
...ily flogged in China, no matter how
...nky the design. Today, though, shop-
...ers demand products with more piz-
...z. For evidence, look no further than
...mobile-phone market. Chinese man-
...ufacturers have tripled their market
...are, to 30% today from 10% in 2001,
...gely because of splashy designs such
...the gem-studded handsets offered by
...International Holdings Ltd. "How
...they sell so well? They under-
...stand local tastes," says Motorola's di-
...rector of consumer design, Kumo Chiu.

GM is hoping for similar success with
the \$21,000 Excelle. The Chinese prefer
more chrome and detailing in their au-
tomobiles, while Westerners go for more
organic styling, says Burt Wong, GM's
top vehicle designer in Shanghai. So the
Excelle's grille is larger than on U.S.
Buicks and versions of the
Excelle that are being sold
elsewhere, and its
wraparound head-
lights are meant to
evoke the eyes of the
mythical phoenix. "A car
needs to show status and
power, but shouldn't be
aggressive," Wong says.

It's not just multina-
tionals that are discover-
ing Chinese designers. Local compa-
nies are also looking to give their
brands a lift through better design.
Lenovo, formerly known as Leg-
end Holdings Ltd., has hired
Ziba Design Inc. of Portland,
Ore., to beef up its design pro-
gram. China's largest TV manu-
facturer, Changhong Electric, and

construction-equipment maker Sany
Heavy Industry Group have hired
S.Point to give their brands more flair.
And white-goods maker Haier Group
established a design unit back in 1994.
Today the clean, cool lines of its refrig-
erators and washing machines help
boost its sales around the world.

Chinese designs are even finding their
way onto shelves of North American
and European stores. Some Philips DVD
players and Ryobi power tools were de-
signed in China. And the pleasing con-
tours of Black & Decker's new irons
came from drafting boards in Guang-
dong. The Chinese "are surprisingly in
touch with design trends," says Steven
Hecker, director of new-product devel-
opment at Applica Consumer Products,
which makes Black & Decker Corp.
small appliances under license.

That means sooner or later China
will be a design force to be reckoned
with. For a glimpse of the future,
check out 28-year-old Fang Zhen, who
works with Sun at GM. He sports or-
ange hair, favors black T-shirts and
cargo pants, and looks to Italy for in-
spiration. "First, I want to be the Gior-
gio Giugiaro of China," says Fang, re-
ferring to the legendary Italian who
designed Alfa Romeos, Lamborghinis,
and the 1967 Oldsmobile Toronado.
"Then I want to be a top auto designer
globally." With that kind of ambition
coming out of Shanghai, designers in
the West may want to keep one eye on
the rearview mirror.

*By Frederik Balfour in Hong Kong
and Dexter Roberts in Beijing*

**WAGNER
DRILL:**
*Designed
by China's
S.Point*



Hundreds of schools churn out grads



COMMENTARY

By Lorraine Woellert

HOW MUCH CAN YOU STILL TELL YOUR LAWYER?

In a world wallpapered with regulation, big companies can't avoid brushing up against the law from time to time. They inevitably hire a small cadre of people who cut corners, ignore procedures, and make deals with the devil. That's why managers are grateful for so-called attorney-client privilege—the bed-rock principle that forbids lawyers to reveal confidential communications with their customers. It's an essential component of our adversarial system—a pledge that executives can confide in their lawyers and develop the best defense possible without fear that sensitive or incriminating secrets will leak out.

But now, this cornerstone of the

American legal system is under attack (table). Angered by evidence that lawyers helped white-collar criminals rip off shareholders, the feds and the courts are starting to shoot new holes in the rule. In January, the Justice Dept. hinted that it would go easier on companies under investigation if they waived the privilege. In June, the Internal Revenue Service went to court to force the Dallas firm *Jenkins & Gilchrist* to name clients who used tax shelters that the agency is investigating. This fall, the Securities & Exchange Commission will begin weighing a proposal that could force lawyers who suspect wrongdoing, and can't make the company stop it,

to resign publicly from a company's service—a process known as “noisy withdrawal.” Even the American Bar Assn. is ceding ground. On Aug. 11, in a divided vote, the ABA altered its ethics rules to allow lawyers to turn in their law-breaking clients.

All of this raises a scary question:

Can you trust your lawyer with your secrets anymore? For the majority of executives, the answer is yes.

Most of the day-to-day questions that executives ask about sexual harassment, workplace safety, intellectual property, and pollution regulations will remain as confidential as ever. But if you are implicated in the wrongdoing—especially if a hot topic like tax evasion or securities fraud is involved—then watch out. A new day has dawned. Your words may come back to haunt you in court. “Clients have to be aware that they are at very high risk of enforcement,” says Keith Bishop, formerly California's top securities regulator and now a partner at *Buchalter, Nemer, Fields & Younger* in Los Angeles.

This is not entirely bad news. Rather than looking the other way when managers misbehave, lawyers are being called upon to be a moral compass for their clients, steering them through the gray area between aggressive practices and outright fraud—and blowing the whistle when necessary. “It will force lawyers to take the blinders off,” says Susan J. Hackett, general counsel of the American Corporate Counsel Assn.

But clearly, executives are going to have to tread more carefully with their attorneys. One area where the impact of the new assault will be felt is independent investigations conducted by outside lawyers after a company gets into hot water—such as the one *Wilmer, Cutler & Pickering* performed for *Enron Corp.*'s directors last year. While such probes were once off limits to federal prosecutors, investigators now target them as an easy source of informa-

ATTORNEY-CLIENT PRIVILEGE UNDER ATTACK

SEC

The agency is weighing a proposal that would force lawyers to resign publicly if clients don't correct a suspected wrongdoing.

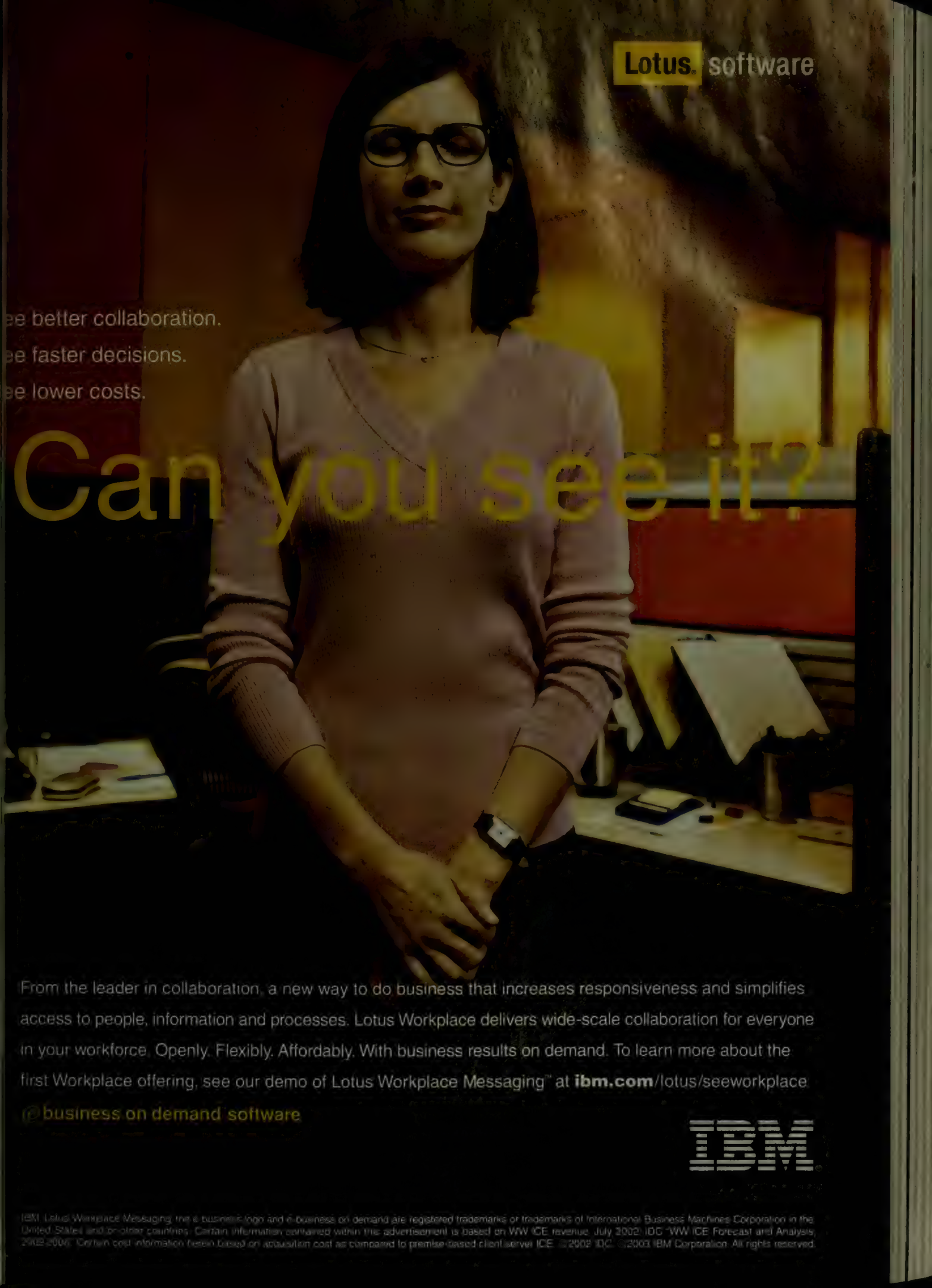
JUSTICE DEPT.

Prosecutors are frequently demanding waivers of the attorney-client privilege from companies under investigation.

COURTS

Judges are forcing companies accused of serious fraud to unseal privileged documents.

Data: BusinessWeek



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tion. The idea behind the policy shift: If Justice can get companies to turn over their own internal investigations, then prosecutors won't have to spend as much money probing white-collar wrongdoers.

Defense lawyers complain that Justice requests for waivers of attorney-client privilege are becoming more routine. That means that executives who cooperate with internal investigations may be putting themselves at risk—a development that is likely to undermine future corporate probes. “The witness understands that he’s basically speaking to the government,” says former U.S. Deputy Attorney General Eric H. Holder Jr. “You’re no longer the lawyer for the corporation. You are, in the view of the witness, an agent for the government.”

Hoping to fend off further assault against the attorney-client privilege, the ABA has made a preemptive strike. After heated debate, the bar’s delegates voted to rewrite their code of professional conduct. The new guidelines allow—but do not require—attorneys to break confidence with a client and report possible corporate fraud to law-enforcement officials. The move is in part an effort to show that the profession can police itself and that the SEC and the Justice Dept. need not attack the privilege. SEC Commissioner Harvey J. Goldschmid calls the ABA vote “constructive.” Nevertheless, he asks, “should lawyers have less responsibility than corporate auditors and independent directors?” Both groups are required to report cases of securities fraud or embezzlement.

That’s a good question. Attorney-client privilege—like property rights, free speech, and due process—has never been an absolute. It is an important value that must be weighed against other values. As the corporate crime wave illustrates, privilege has plenty of potential for abuse. Now it is being scaled back a bit. But unless you have really pushed the boundaries of the law, you can still trust your attorney.

*With Paula Dwyer
in Washington*

People



BATTLING IMPORTS: Koch says he has no plan to sell the Boston business

ENTREPRENEURS

KEEPING THE FROTH ON SAM ADAMS

Will Jim Koch's beer ever be hip again?

Just as Jim Koch is about to paste a sticker for Samuel Adams beer on the cooler of a Manhattan supermarket, the red-faced manager appears. “Don’t you dare put anything on my shelves without my permission,” he fumes. The brewer musters his most disarming smile and extends his hand. “Hi,” he says in the voice made familiar by 15 years of cheeky radio commercials. “I’m

Jim Koch, of Samuel Adams beer.” The manager is unimpressed: “It’s a little late for that,” he says curtly. “Please leave my store immediately.”

For C. James Koch (pronounced “Cook”), who just stepped off the 7 a. shuttle from Boston, it is not an auspicious start to a day that will be speckled like many others, trolling through convenience stores, supermarkets, taverns



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and nightclubs talking up his brand to sometimes indifferent retailers. But as he quizzes barkeeps about what's selling and checks the temperature of the Sam Adams drafts he orders, he also receives praise for the quality of his beer, especially his popular low-cal offering, Sam Adams Light. "Not a bad way to spend a day, huh?" the chairman of Boston Beer Co. grins as he lugs a canvas briefcase full of samples down Fifth Avenue in the midsummer heat.

Not bad—but not exactly the easy life, either. The 54-year-old Koch, son of a fifth-generation brewer, has been hustling ever since he cooked up his first batch of Sam Adams, based on an old family recipe, and began selling it bar to bar in Boston in 1985. He could have sold out to a megabrewer long ago and settled into a cushier existence. In fact, Koch says he has enough money that he doesn't have to work, but never could fathom the idea. "What would I do if I did sell?" he asks. "I'd go looking for a brewery to buy so I could launch my own brand." As for why he still pounds the pavement, Koch offers a cosmic explanation: "From the meta-marketing to the store shelves, it's all seamlessly connected," he says. (Can you tell he was once a consultant for Boston Consulting Group?) But it's clear that the real reason is more personal: He still gets an adrenaline rush from meeting his customers face to face, indignities and all. "Beer is very complex, and somebody has to love the beer and protect the beer," he says.

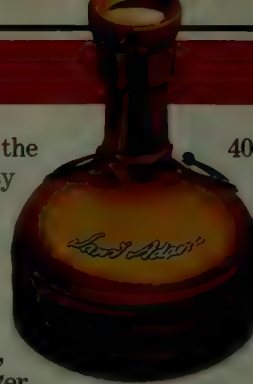
Yet if Koch himself shows no sign of fatigue, his brand is definitely betraying signs of age. Once a cutting-edge alternative to stale imports and bland domestic beers, Sam Adams now is just another craft beer on a cluttered shelf. The best-selling one, yes, but one that isn't drawing in many new drinkers. Among young males for whom beer is something like a fashion accessory, it's the brand their fathers drink. Instead, many are choosing more recent creations such as Fat Tire and Magic Hat, exotic-seeming imports like Belgium's Stella Artois, and even ancient domestic brands like Yuengling and Pabst that have been under the radar so long they are novel again.

To sell Sam Adams to twentysomethings, Koch has been rethinking everything from his advertising to his assort-

ment of beers. He has tilted the marketing budget toward noisy TV commercials rather than the conversational first-person radio ads that helped establish the brand. He has been flaunting his brewing prowess with 50-proof, \$100-a-bottle Utopias, probably the strongest beer ever made. He even launched Sam Adams Light in 2002, after years of deriding the very idea of a light beer.

It's still not exactly clear, however, what persuaded Koch to cooperate with a pair of radio shock jocks who cooked up a promotion dubbed "Sex for Sam" that offered a trip to Boston to the couple who engaged in sex in the riskiest places. When, in August, 2002, a Virginia couple trying to win the prize were arrested for allegedly having sex in New York's Saint Patrick's Cathedral, Koch was in the radio studio. Not exactly the kind of attention he was hoping for. Koch apologized, and the show was canceled.

Still, for six long years, Boston Beer was stuck at about \$200 million in sales. Last year, sales spiked up to \$238 million but have softened this year. As bad as that looks, other specialty brewers suffered far more in what by the late 1990s had become a brutally overcrowded marketplace. In the past two years, Boston Beer's stock has risen



40%, to \$15 a share, outpacing gains of Coors and Redhook. Still, that's only about 1% of what it's worth after its initial public offering in 1996. And although Koch bristles

**50-PROOF
UTOPIAS
MAY BE
THE MOST
POTENT
BREW OUT**

the "father's beer" tag, he admits to trying to reach a new generation. It's been a humbling experience. "I know that Sam Adams still stands for quality, passion, authenticity, and innovation, but I don't know how to communicate that as a 23-year-old," he says.

It's a strange admission from a man who has long irked rivals with his humor. "In the early days, Koch was easy to dislike—and so successful," says John McDonald, founder of Boulevard Brewing Co. in Kansas City, Mo. "Now I think he's O.K." Koch has always been a pinstripe-suited presence in a denim-clad world. He grew up in Cincinnati, earned degrees in government, business, and law from Harvard University, and along the way became a climbing instructor for Outward Bound. Today he is a closet vegetarian.

Now, despite the bravado, some credit to him say he's softening a bit. Koch is notoriously parsimonious: He and his second wife, biotech entrepreneur Cynthia A. Fisher, live in the same modest house in Newton, Mass., that he bought 20 years ago. But he finally splurged this spring on a weekend place in South Dartmouth, Mass., and this summer decided to take Fridays off.

And, who knows, Koch may decide it would be even better off selling the company to someone who could really scare the imports. While he wouldn't walk away with as much as he might have in Sam Adams' heyday, he could pocket at least \$70 million. And it is still his choice: sole owner of the company's Class A shares (in all he has about a 33% stake in the company), Koch has effective veto power over any decision to sell. "While I would never entertain the subject in the past, he's more willing to talk about these days," says board member Jean Michel Valette. Still, Valette adds, "it's a notion of unfinished business that's motivating him." Enough encounters with surly store managers, and even that could lose its charm.

By Gerry Khermouch in New York



JIM KOCH

BORN May 27, 1949, in Cincinnati

EDUCATION B.A., government, Harvard University, 1971; J.D./M.B.A., Harvard, 1978

CURRENT POSITION Runs Samuel Adams marketer Boston Beer, which he founded at age 35

FAVORITE BREW 50-proof Utopias, a high-alcohol specialty beer he produces

BIGGEST CHALLENGE Grabbing the attention of twentysomething men who think of Sam Adams as their fathers' beer.

FAMILY Married 10 years to his second wife, Cynthia A. Fisher, a biotech entrepreneur; four kids—two from each marriage

BusinessWeek tv

Tune into BusinessWeek TV for an interview with Jim Koch. For program dates and times in your area, go to www.businessweektv.com

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"I Can't Remember"

We are who we are in good measure because of what we learned and what we remember."

—Nobel Laureate Dr. Eric R. Kandel

The 76-year-old California lawyer appears to be the very model of healthy aging. C.L., who asked that his name not be used, hikes two miles up a nearby mountain four times a week, is always reading two or more nonfiction books at a time, and boasts that his waist and chest measurements haven't changed since he was 25. This take-charge guy expects a lot of himself. But for the past six years, his memory

isn't measured up. He occasionally forgets a name, he loses his train of thought when there are distractions, and he has walked away from six pairs of expensive sunglasses. "People who are very well-mannered intellectually notice when they begin to lose that ability to get onto every word, every concept," he says. "It's like a significant part of your life is erased."

C.L. yearns for some kind of treatment—and his determination is a powerful message to the drug industry. Although he is functioning very well for his age, he has tried hard to enter a clinical trial for an experimental memory drug developed by Cortex Pharmaceuticals Inc. of Irvine, Calif. The compound, called CX516, is in Phase 2 clinical trials for people who suffer

from frequent short-term memory lapses, a condition called mild cognitive impairment (MCI). It is an ominous diagnosis, even though the condition doesn't interfere significantly with daily living, because it can be an early warning sign of something much worse. Every year some 15% of people with MCI go on to develop Alzheimer's disease.

C.L. took nine capsules of CX516 daily for 12 weeks last spring. The impact was immediate. "At the start of the study, I could remember less than five words out of a list of 20. By the second week, I could get 14 out of 20. There was a very, very appreciable enhancement." He has since dropped his part in the study and says it was "heartbreaking" to go off the drug. "I've been thinking of some other

way to get it, and I don't give a damn if it's legal or illegal."

If he waits a few years, C.L. should be able to solve his problem legally. At least 60 pharmaceutical and biotech companies around the world are working on novel memory pills. Some 40 are in human trials, and the first of these could be on the market within the next few years. These drugs aim to do far more than relieve the occasional "senior moment." Neuroscientists are hoping that any pill that improves memory in the elderly will also protect against Alzheimer's disease, the diagnosis old people fear most. "Within five years, we will have treatments that slow the rate of decline or even delay the onset of Alzheimer's by five years or more," predicts Dr. Leon J. Thal, chairman of the Neurosciences Dept. at University of California-San Diego.

Cover Story

Drugs to stave off age-induced memory impairment may be on the horizon

BY CATHERINE ARNST

The drug industry is spending billions of dollars to come up with such a pill, and it's not hard to see why. In 10 years, all 77 million baby boomers will be 50 or older, and as many as 25% of them may develop some form of dementia. They do not, however, show any interest in going gently into that good night. As Harry M. Tracy, publisher of the newsletter *NeuroInvestment*, notes: "This is a generation that does not accept decline."

It's also a generation that is approaching the danger zone. The brain reaches its maximum weight by age 20 and then slowly starts shrinking, losing 10% of its volume over an average lifetime. It's virtually inevitable that mental glitches will show up by

the time we are eligible for senior-citizen discounts, and people are noticing. Surveys have found that 75% of people over 50 believe they suffered memory problems over the prior year.

Some of these people may be overreacting—but a large proportion aren't. At least 20 million Americans over 60 have some level of memory impairment short of dementia. Another 4.5 million are victims of Alzheimer's, a progressive brain disease that over the course of a decade destroys memory and other cognitive functions until its victims are virtually helpless. The longer one lives, the greater the danger—50% of people age 85 and over end up with Alzheimer's.

Since more of us are living to an old, old age, trend lines for memory loss all point upward. The Alzheimer's Assn. esti-

mates that by 2050—when the number of people over 65 will have doubled, to 70 million—there will be 13.2 million Alzheimer's victims. Run the numbers, and it's obvious that a pill that promises to protect against this terrible malady would dwarf the \$1.7 billion a year pulled in by Viagra, that other salve for an aging body.

That such pills are even in the pipeline is something of a scientific miracle. The human brain is medicine's most daunting frontier. Made up of more than one trillion highly complex neurons, it remained obdurately opaque long after the body's other tissues had given up many of their mysteries. But in the past decade, the code has been partially cracked. Using sophisticated imaging technologies, animal experiments, and genetic insights, scientists now have a road

map of the complex process that is memory formation.

Products follow knowledge. The first drug able to prove the thinking abilities of people with advanced Alzheimer's disease was approved in Europe last year and widely expected to win the nod from the Food & Drug Administration this fall. Memantine, developed by the German company Merz, is no miracle cure, and it has shown little effect in Alzheimer's patients in the earliest stages of disease. But clinical trials demonstrated that the drug allowed the most desperately confused patients to live independently for six months to a year longer than they would otherwise with no debilitating side effects. That's more significant than it may sound: Alzheimer's is the No. 1 cause of institutionalization in the U.S.

Remembering...

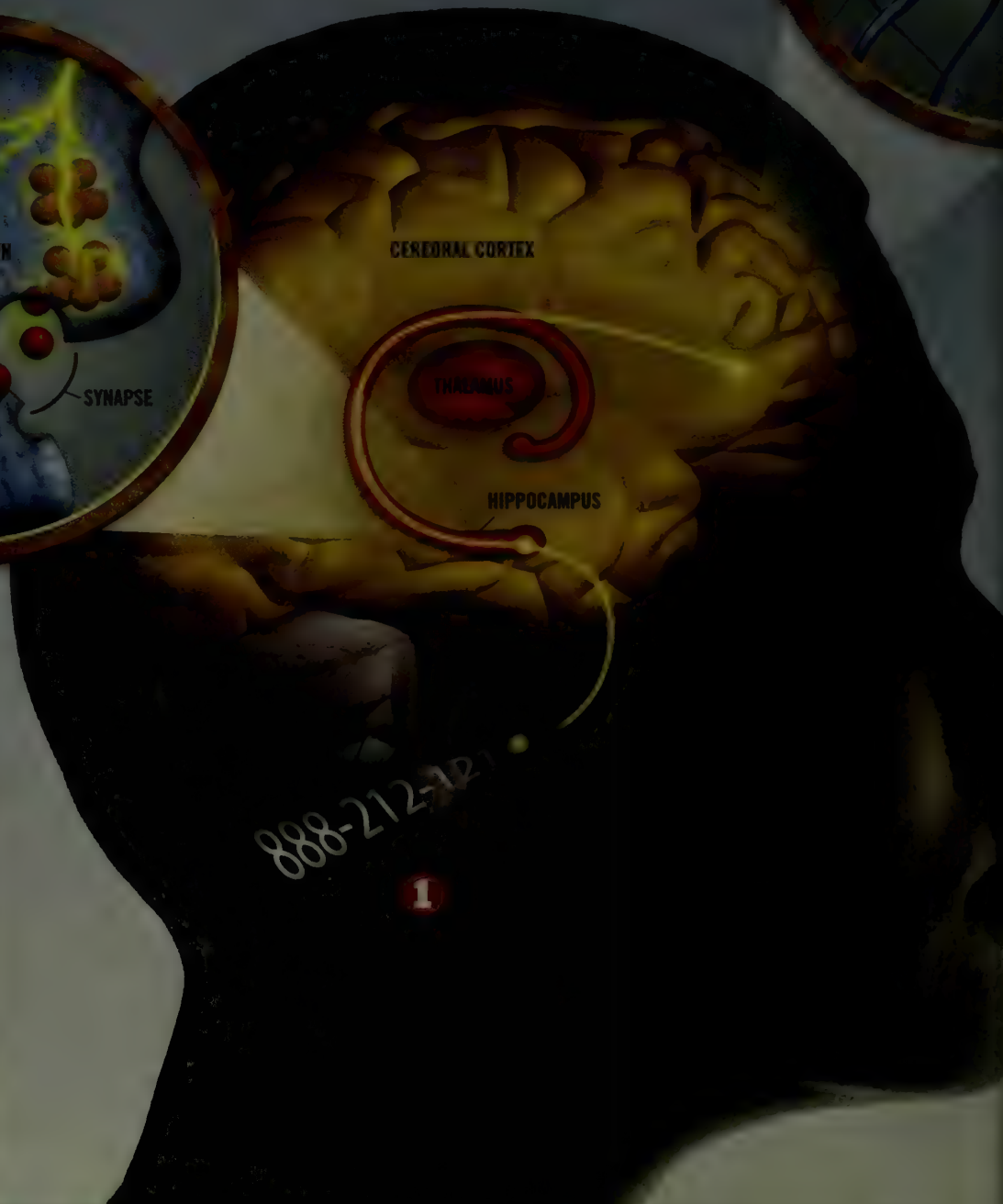
1 A phone number you've just heard is captured by the brain's cells, or **NEURONS**, as a pattern of electrical signals that transport it to a processing center deep inside the brain called the **HIPPOCAMPUS**, responsible for learning and memory.

2 Once the phone number is lodged in the hippocampus, a cascade of brain chemicals called **NEUROTRANSMITTERS** is released. These messenger chemicals carry the information across tiny gaps, called **SYNAPSES**, connecting the neurons.



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The brain contains over a trillion neurons that constantly reconfigure themselves to form new memories or purge old ones. When everything is going right, they perform this task more efficiently than the world's fastest supercomputers.



n trials; healthy pilots who took an Alzheimer's drug experienced **MEMORY IMPROVEMENT**

Memantine marks the first big payoff of brain research carried out over the past decade. The three treatments for Alzheimer's now on the market—Pfizer's Aricept, Novartis's donepezil, and Reminyl from Johnson & Johnson—all boost the levels of a brain chemical called acetylcholine, and first appeared in the early 1990s. These drugs can delay the downward trajectory of patients in early stages of the disease for several months, but they do not improve thinking power and can

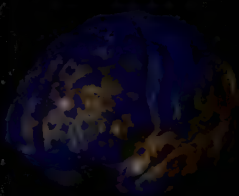
3 The **NEUROTRANSMITTERS** deliver the phone number to the appropriate area of the brain for storage. The stronger the **MEMORY**, the more synapses are created, strengthening the connections between neurons. Eventually, a group of neurons band together to form a long-term storage space for the information, a process that can take hours or days.

Forgetting

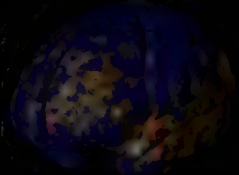
By the time you turn 50, memory-formation slows down as cells naturally die off or are ravaged by disease. **AGE-ASSOCIATED MEMORY IMPAIRMENT** can develop, a condition characterized by momentary gaps in memory.

Continued memory loss, called **MILD COGNITIVE IMPAIRMENT**, could be a warning sign that clumps of an abnormal protein called amyloid are accumulating in the hippocampus and elsewhere. The amyloid disrupts neurons and interferes with neurotransmitters, throwing the memory-encoding process out of control. This marks the start of **ALZHEIMER'S DISEASE**, a degenerative condition that begins with the loss of short-term memory and eventually affects all cognitive functions—a process that can take up to 12 years.

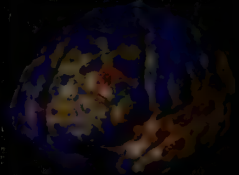
The Spread of Alzheimer's Disease



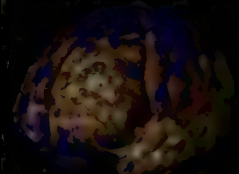
Initially



6 months later



12 months later



18 months later

■ Healthy tissue
■ Dying tissue

ALZHEIMER'S IMAGES COURTESY OF PAUL THOMPSON, KIRALEE HATASHI, AND ARTHUR TOGA, UCLA SCHOOL OF MEDICINE

cause nausea, loss of appetite, and frequent bowel movements.

Memantine is a smart bomb by comparison. It targets a cell receptor that controls the intake of glutamate, a neurochemical that scientists believe is responsible for 75% of the communications between brain cells. "Memantine represents real progress, a meaningful therapeutic advance," says Dr. Pierre Tariot, a University of Rochester psychiatrist.

Neuroscientists eagerly anticipate more such advances. Even now, the contours of an enormous memory industry are coming into view. Just look at the herbal supplement ginkgo biloba: Annual sales reached an estimated \$500 million in the U.S. last year, although clinical trials have disproved claims that it can boost memory. The three Alzheimer's drugs now available had combined U.S. sales of more than \$1 billion, despite their shortcomings. Memory clinics are springing up around the nation, headed by everyone from top-ranked neurologists to New-Age practitioners, while bookstore shelves are stuffed with how-to guides on memory maintenance.

Even the federal government is in on the act. The cost of caring for Alzheimer's victims in the U.S. will total over \$100 billion this year, making the disease a top priority of the National Institutes of Health. It is sponsoring a dozen or more clinical trials of potential memory enhancers in the hopes that something, anything, will be found that can delay the slide into dementia. Anti-inflammatory treatments such as aspirin and Celebrex are particular favorites for study, because inflammation in the brain is a hallmark of Alzheimer's disease. Vitamin E also has attracted interest in the hope that it may protect brain cells from damaging molecules called free radicals that course through the blood and batter healthy cells. Plenty of other potential remedies are being tested as well, among them estrogen, blood pressure medications, cholesterol-lowering drugs, memory exercises, and special diets—including curry (because India has the lowest incidence of Alzheimer's in the world).

Most experts, though, believe that a drug specifically designed for memory loss will be far more effective than any jerry-built treatment—and more lucrative for the inventor. Medical experts estimate that about 8 million people in the U.S. over age 50 suffer from mild cognitive impairment, and drugmakers do not plan to stop there. Any pill that wins FDA clearance for cognitive impairment will surely be tested against the next gradation of fuzzy thinking: age-associated memory impairment. The signs of this condition include the occasional misplacing of car keys or failure to recall a well-known name. As many as 12 million Americans suffer from such lapses.

If a pill that treats such minimal memory loss wins FDA approval, it's not hard to imagine the next step down this slope. A drug that can stave off age-associated memory impairment will surely appeal to the enormous cohort that the medical establishment refers to as the "worried well." These healthy, well-functioning individuals share a common fear: that forgetting a name every now and then is the first step toward dementia. "About half of my patients are around 50 and self-referred because they are just worried," says Dr. Gayatri Devi, director of New York Memory & Healthy Aging Services, a Manhattan-based clinic. "Because their functioning seems impaired, some of them come in convinced that they have Alzheimer's."

Next in line for memory pills could be college students seeking to improve test scores. Drug developers all insist they

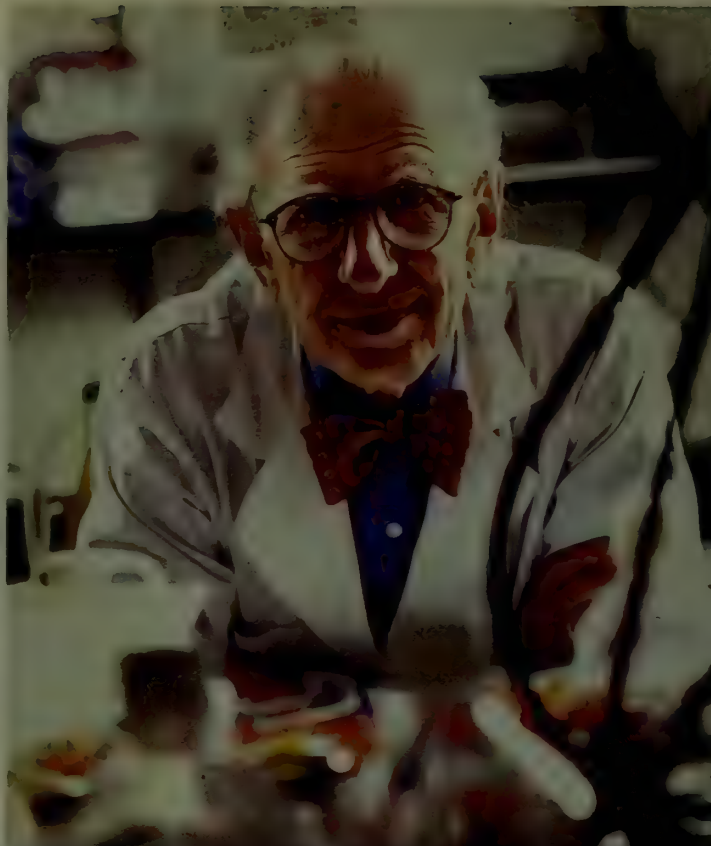
Cover Story

have no interest in selling memory pills to the young and healthy, but that may not matter: There is already evidence that even nimble memories can be improved. In a groundbreaking study published last year, Peter J. Whitehouse of Case Western Reserve University gave nine healthy aircraft pilots—mean age 52—a daily dose of Aricept, Pfizer's drug for mild Alzheimer's. They were matched with another nine pilots who received placebos. After 30 days, the Aricept pilots were measurably better able to perform a set of complex flight-simulator tasks than the placebo group.

Far more tests will be needed to determine if Aricept, or any other drug, would have the same effect in a larger population. Besides, given its unpleasant side effects, it's unlikely Aricept would ever become a popular "smart pill." Nevertheless, the success of the pilots' study does demonstrate that memory-enhancing pills are possible.

It won't be all that easy, however, to push through a medication that tampers with the body's control center, the brain. "The FDA is going to be very careful about the safety profile of any drug that might be taken by millions of otherwise healthy people," says NeuroInvestment's Tracy. "These drugs have a very high hurdle to leap, much higher than Alzheimer's [medications]." Experimental brain drugs have often failed in clinical trials because of dire side effects. Witness the fate of a promising Alzheimer's vaccine by Elan Pharmaceuticals. Development was halted last year, even though the drug was able to reduce levels of the disease in a clinical trial, because some patients died of brain inflammation.

The Elan experience was not the only time that doctors harmed the patient while trying to heal the brain. A breakthrough insight into memory was borne out of an attempt to cure epilepsy that went terribly wrong. In 1953, a Hartford surgeon, in an effort to rid a 27-year-old man of seizures, re-



KANDEL: *His discoveries have led to six memory-impairment drugs now in the pipeline*

removed a small structure deep in the brain called the hippocampus. He cured the seizures,

but the patient, known as H.M., never formed another memory. He can recall events from before the operation but has no memory at all of a conversation held minutes earlier. He lives in a perpetual present. H.M.'s tragic case proved that the hippocampus is where fleeting impressions turn into permanent memories.

Each sensation that enters the hippocampus, be it a spoken name, some visual impression, or the instructions for a new cell phone, sets off electrical charges inside neurons, the cells that make up the brain. The charge stimulates the cell to release a roiling stew of neurotransmitters, which carry the information across tiny gaps called synapses that connect the neurons to one another. The longer these millions of signals flash back and forth, the stronger the connections become and the more synapses are created—a single neuron can have as many as 10,000 synapses. Finally, a set of neurons bands together to retain the data, and

the brain remolds itself to create storage space. The entire process, from the time a number is heard until it is permanently stored, can take hours or even days.

As we age, the brain can't execute this complex dance as quickly. A recent study from the University of Kentucky suggests that the genetic changes behind the mental slowdown may start by age 40, with results showing up a decade or two later. That doesn't mean we have no choice but to grow continuously dumber. Even when the brain's ability to absorb new information slows, it gets better at storing and calling up information it already has, based on past experience. Age really does beget wisdom.

Continued mental activity might also ward off dementia. Several studies have lent credence to the "use it or lose it" strategy. The most recent, published in June by the Albert Einstein College of Medicine in New York, followed 469 people age 75 or older for five years. Those in the top third of mental

activity had a 63% lower risk of dementia than those in the bottom third. Taking part in a single absorbing mental activity a day a week reduced the risk by 7%. However, some scientists wonder if Alzheimer's may have already taken root in the study participants who weren't as mentally engaged, which would explain their lower ranking.

It is almost certainly helpful to start the mental challenges much earlier. Study after study has shown that people with limited or no formal education before the age of 10 are at a higher risk of Alzheimer's later in life. It may be that intense learning when the brain is young and plastic greatly increases the number of synapses. The brain can call on these reserves at any age, or in case of injury, such as a stroke. This is when the piano or French lessons your parents forced on you as a child might pay off. "The more synapses you form in your lifetime, the more you can tip the balance in your favor as you age," says Dr. Majid Fotuhi, a neurologist at Johns Hopkins Hospital and author of the book *The Memory Cure*.

Unfortunately, memory can slip away from even the brightest. W.D., a 78-year-old doctor in Maryland, retired in 1993 but continued to be very active. Four years after he started noticing problems. He would forget where he was going in his car or what restaurant he had just eaten in. "I used to be clear as a bell, and now I have to stop and think about where things are," he says. His doctor ruled out Alzheimer's, but that just makes him wonder what is going wrong. "It's depressing."

Doctors have no way of predicting who is at risk for such debilitating memory loss. They can't even diagnose Alzheimer's with certainty until after the patient's death: It is then that clumps of rock-hard plaque in the brain can be detected during autopsy. This plaque is caused by the buildup of a protein called amyloid, which slowly destroys neurons, starting in the hippocampus. It is unclear whether amyloid is a cause or a symptom of Alzheimer's, but scientists are fairly certain that it starts accumulating 10 to 20 years before mental decline

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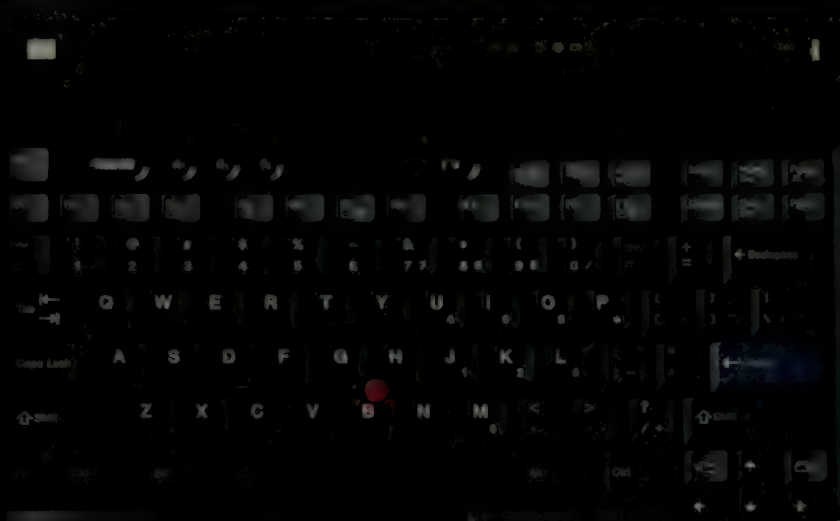
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MENTAL CHALLENGES early in life—such as piano lessons—may enhance memory later on

evident, by which point it is too late to reverse the process. "The current Alzheimer's treatments are an act of despair," says Dr. Eric R. Kandel, professor of psychiatry at Columbia University. "We have to start [intervening] much earlier if we want to make a difference."

Ergo the focus on early memory loss, when the brain may still have a chance to save itself. Success in this area will owe much to the study of animals that likely have far less to remember than humans. It seems that brains of insects, apes, and

people work in much the same way. Kandel shared the 2000 Nobel prize for medicine for

Cover Story

his breakthrough discoveries about memory that grew out of painstaking work with sea slugs. Kandel's discoveries were amplified by Tim Tully, a fellow of Cold Spring Harbor Laboratories on Long Island, whose research is based on the brains of fruit flies.

Work on these two lowly life forms led to a revolution in the understanding of memory. Kandel discovered that a neurotransmitter called cyclic-AMP, or cAMP, plays a key role in strengthening synapses. cAMP activates a protein called CREB, which in turn switches on the genes that control the release of neurotransmitters essential to long-term memory. "Think of CREB as a general contractor that organizes the cascade of genes that build memories," says Tully.

Once CREB was discovered, Tully went to work designing a strain of fruit flies with the CREB protein permanently activated. The result: flies with photographic memories. The CREB flies could remember how to find sugar water in a specially designed tank after only one try, while average flies would have to go through multiple training sessions.

Both Kandel and Tully have formed companies to pursue their discoveries, specifically by targeting mild cognitive impairment and age-associated memory impairment. Kandel's firm, Memory Pharmaceuticals Corp. of Montvale, N.J., is the furthest along, with drugs that block the breakdown of cAMP. Memory Pharmaceuticals scored a \$150 million partnership with Roche Holdings Ltd. and has six drugs in the pipeline, including one in early-stage human testing. Tully's Helicon Therapeutics Inc., in Farmingdale, N.Y., is still in the lab with drugs designed to boost the activity of CREB and has had promising results in mice.

The renowned reputations of Kandel and Tully have given their companies cachet. But even Tully acknowledges that any memory enhancers developed by Helicon "promise to be only one in this newly emerging sector of the drug industry." Several other candidates are much further along (table).

Most of these drugs can be divided into two camps, defensive and offensive. They either amplify neurotransmitters that strengthen memory formation or block those that get in the way of that process. Cortex Pharmaceuticals, for example, is investigating a group of drugs called ampakines that amplify the neurotransmitter glutamate, stimulating it to produce more synapses. The furthest along of these is CX516, the drug tested on C.L. In early trials, CX516 boosted memories in healthy

65- to 75-year-old volunteers more than twofold over a placebo group. The drug also improved cognitive performance in a small group of Swedish medical students, an intriguing hint the drug may work on the young as well as the old. Cortex is conducting a 150-patient clinical trial in patients with mild cognitive impairment, in partnership with Les Laboratoires Serono of France, scheduled to finish this year.

The defense strategy is being pursued by Saegis Pharmaceuticals Inc. of Half Moon Bay, Calif. Its drug, SGS742, blocks GABA, a neurotransmitter which can inhibit memory consolidation. The results of a completed Phase 2 trial for MCI have yet to be published, but Saegis Chief Executive Rodney Peman says: "We did see a statistical significance over the placebo group."

There are plenty of existing compounds under investigation as well. One closely watched trial sponsored by the NIH will determine if statins, the popular cholesterol-lowering drugs such as Zocor and Lipitor, can slow memory loss. Such a connection makes sense, says Dr. Kenneth Davis, head of the Alzheimer's Disease Research Center at Mt. Sinai Medical Center in New York, because the plaque that clogs arteries in patients with high cholesterol has certain commonalities with the plaque found in the brains of Alzheimer's patients.

It will take several years before any of these large prevention trials produce definitive answers. By then, one of many memory pills in the works could also be available.

Memory Magic

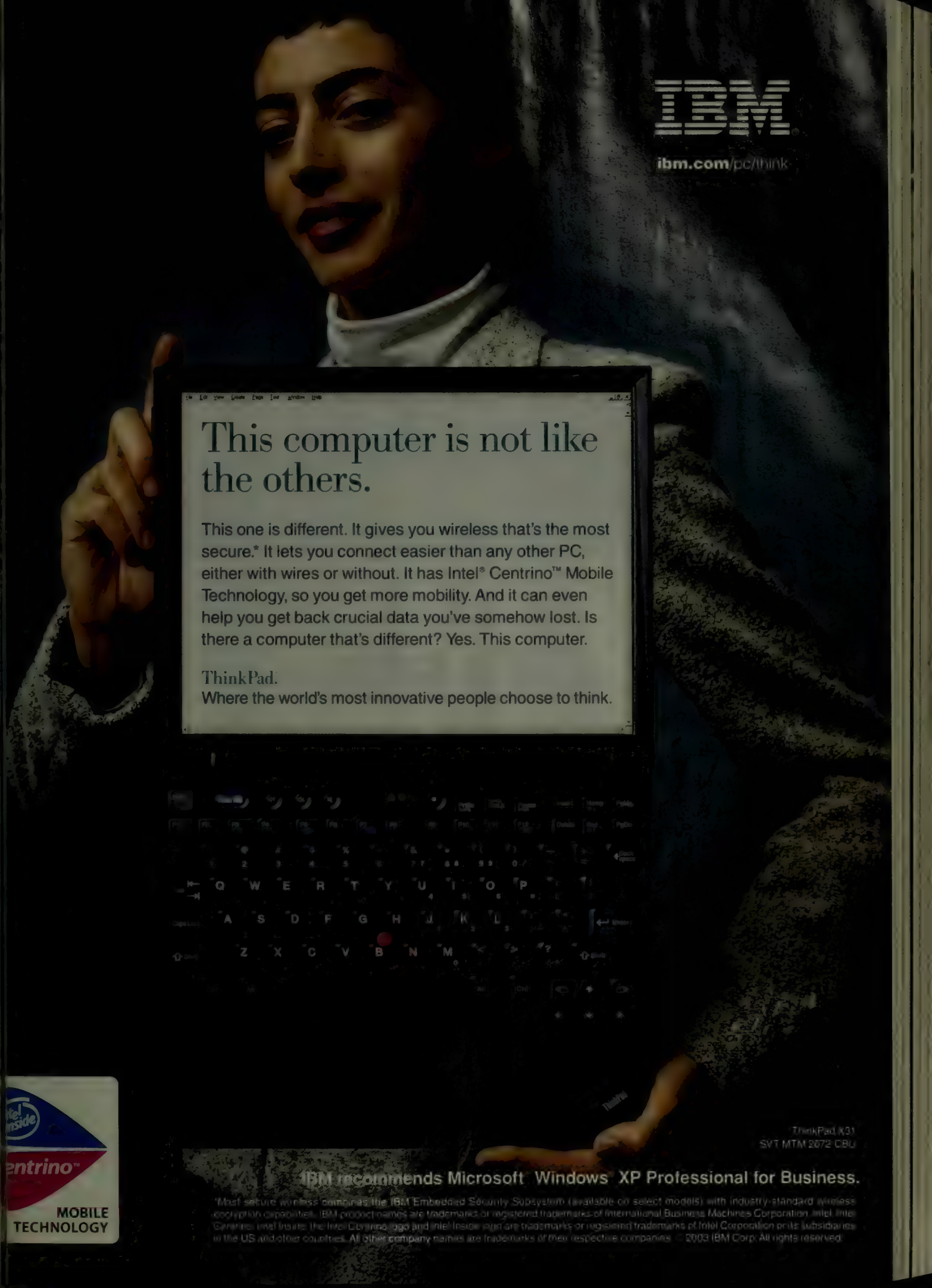
More than 40 experimental drugs meant to enhance or protect memory are in clinical trials. These are the leading contenders

DRUG	TARGET	STATUS
SGS742 Saegis Pharmaceuticals	Blocks a neurotransmitter that inhibits memory loss	Phase 2 trials
CX516 Cortex Pharmaceuticals	Enhances a neurotransmitter that solidifies memories	Phase 2 trials
MEM 1414 Memory Pharmaceuticals	Inhibits an enzyme that breaks down cAMP, a key memory transmitter	Entering Phase 1 trials
ARICEPT Pfizer	Approved for Alzheimer's, it inhibits an enzyme that breaks down acetylcholine, a brain chemical linked to memory	In trials for mild cognitive impairment
NEMANTINE Merz/Forest Labs	First drug to improve cognition in moderate to late-stage Alzheimer's patients	Awaiting FDA approval

that point, people who suspect declining memory might visit a special clinic where they will take a battery of tests to assess cognitive function. Based on the results, they will be given a set of brain exercises and prescribed a memory drug. "This, in the long run, will yield lasting improvements in our abilities to perceive the world around us and remember our contributions to it." It is a vision everyone on the far side of the chasm can embrace.



For additional coverage, including video interviews, go to www.abcnews.com



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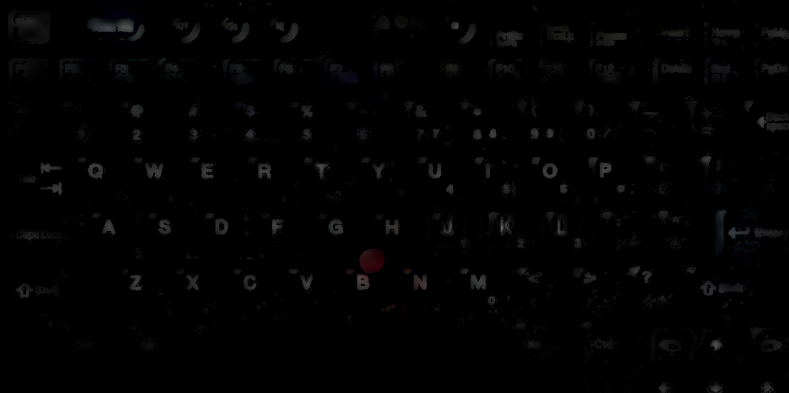
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CLOTHING

TALBOTS GOES FOR TESTOSTERONE

Just as menswear is fraying, the chain is trying it on

Retreat has been the order of the day for many players in the miserable menswear market. No wonder. "These days, the No. 1 reason a guy buys new clothes is that he has gained weight or his clothes are frayed," says Marshall Cohen, chief industry analyst for NPD Group Inc. The firm, which tracks consumer buying trends, says men's clothing has been in decline for a couple of years, and it estimates that U.S. sales slipped 0.8% more, to \$51.9 billion, in the 12 months ended in May.

So why does Arnold B. Zetcher, chairman and CEO of Talbots Inc., think this is the perfect time to plunge into menswear? Think of it as buying at the bottom of the market. "As we hear other people are having difficulty, that says to us we should be in the men's business," says Zetcher. And never mind that Talbots—one of the nation's best-known women's specialty retailers, with more

than 900 stores—has no experience selling clothes to men. Zetcher believes his fanatically loyal female customers shop for the men in their lives—or at least can be counted on to drag husbands and boyfriends into stores that Zetcher says will be heavy on ambience and service.

In early September, Talbots Mens is opening shops on New York's Madison Avenue, plus Boston and the Washington

A Tight Fit in Menswear

With men's clothing in a slump, here's how Talbots' competition stacks up:

DARING: Talbots Mens is featuring bright colors area, join three stores opened in visible locations spring. The just the

assault in a campaign will lead to a nationwide men's chain with "hundreds" of outlets, Zetcher—rivaling Brooks Brothers' more than 1,000 stores. "We want to do what the upscale men's operators are offering at a more moderate price level," he says. Talbots Mens will shun suits, concentrating on sportswear ranging from chinos to dress trousers, sweaters and sports coats.

Many local menswear shops have bitten the dust in recent years, and sales at men's specialty stores haven't budged

a decade. But some of the big chains haven't given up. Brooks Brothers, under new owner Claudio Del Vecchio, is aggressively promoting its claim of improved quality. Men's Wearhouse credited strong suit-buying activity with an 8% gain in U.S. same-store sales during the 13 weeks ended Aug. 2. And a surprising number of retail gurus say Zetcher may be on to something by offering a fresh assortment with more service. "Most men are terrible clothing buyers who need a lot of hand-holding," says Emanuel Weintraub, who runs retail consulting firm in Fort Lee, N.J. "Yet the department stores have abandoned that level of service."

Clearly, there is opportunity to expand with the right men's offerings. Jos. A. Bank Clothiers Inc. chain has just 100 stores in 1999 and is now up to 180. It plans to have 500 open by 2003. Bank sells moderately priced suits and sportswear with attentive service. Si-

BROOKS BROTHERS Lost its way in the '90s, but aims for a turnaround under new owner

JOS. A. BANK CLOTHIERS Venerable chain now expanding rapidly, stressing service and selection

MEN'S WEARHOUSE Seeing a recent uptick in sales of affordable suits at its nearly 700 stores

DEPARTMENT STORES Still a big factor, but losing share with little service and lots of promotions

LOCAL SPECIALTY SHOPS They've taken the heaviest hit, with many closing their doors

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CEO Robert N. Wildrick took charge of the century-old Bank in '99, net income has soared sevenfold, to \$10.9 million, as sales jumped 25%, to \$243 million.

But is Talbots positioned to make a similar leap? Its pricey women's offerings have suffered in the economic downturn—in the quarter ended Aug. 2, same-store sales fell 1.7%. Overall sales have been stagnant for two years, at around \$1.6 billion, and net income for the 12 months ended Feb. 1 slid 5%, to \$120.8 million. And it may be a challenge to lure some men into stores they associate with women's wear. "A man is going to feel like he's shopping at his wife's store or his mother's store," argues Robert Lepre, a principal at New England Consulting Group. To counteract that image, Talbots is going to great lengths to differentiate its men's stores, with a more masculine design and lots of male sales associates.

That said, David Dirienzo, head of Talbots Mens, contends that Talbots' female customers are the chain's "secret weapon." The truth is, women buy about half of all men's clothes. Anne Hames, who says "90% of my clothes are from Talbots," buys most of the clothes worn by her husband, a physician in west Tennessee. She began ordering from a Talbots Web site last year. Says Hames: "They're a whole lot nicer than L.L. Bean and far superior even to Brooks Brothers."

Zetcher is bucking industry-generated hype that suits are making a comeback. He's probably right—an annual survey of households by research consultants Retail Forward found that just 5% of American men regularly wore a suit to the office in 2002, down from 14% as recently as 1997. Instead, Talbots Mens will offer the same kind of conservative, classic sportswear Talbots now sells to women, aimed at affluent men age 35 to 55. To set its private-label duds apart, Talbots is featuring such surprising colors as raspberry, Nantucket red, even lavender. And it's shooting for designer quality: sweaters with blends of alpaca and cashmere, and khakis made of three-ply Italian fabric. Prices range from \$55 for a pair of chinos to just under \$400 for sport coats.

For now, Zetcher is hedging his bets. He's opening just six stores this year, another six in 2004, and says he doesn't expect the "real rollout" to begin until late 2005 or even 2006. "They're awfully late," argues Bank's Wildrick. "I'll have 150 more stores open by the time he gets his first 15 up." The slow rollout gives Zetcher plenty of time to pull the plug if the concept flops. But if it doesn't, Talbots could become as dependable a choice for men as it is for women.

By William C. Symonds in Boston

The Corporation

BANKING

WACHOVIA'S \$400 MILLION HUNCH

Its deal for Prudential's brokers is a bold contrarian bet

When G. Kennedy Thompson took the helm of First Union Corp. in early 2000, it quickly became clear he was cut from a different cloth than his predecessor, Edward E. Crutchfield Jr. The blustery Crutchfield was known for his aggressive dealmaking: He once boasted that to land one of the 70-plus banks he bought during his tenure, he "just kept stacking billion-dollar bills on the table" until the other side caved in.

Thompson, however, prefers a more understated strategy. After approaching fellow North Carolina bank Wachovia Corp. in 2001 about a "merger of equals"—one that gave Wachovia shareholders a scant 6% premium on their stock—Thompson covertly drove week after week to a Comfort Inn in rural Salisbury, N.C., to win over Wachovia's top executives. As Thompson, who even at age 52 looks ever the Boy Scout, returned the key after one such afternoon tête-à-tête with Wachovia CEO L.M. Baker Jr., he sheepishly asked the desk clerk: "Ever had anybody check out so soon?" Replied the clerk: "Not anybody that looks like you."

The deal, sealed on Sept. 4, 2001, showed that Thompson could pull off a major buyout on the cheap. He persuaded Wachovia shareholders to forgo the usual big up-front premium and has since integrated the banks without the customer defections that dogged Crutchfield in his last deals. Thompson, a 27-year First Union veteran who made his mark heading up corporate and investment banking, also made money for shareholders. Operating income for the bank, now known as Wachovia Corp., nearly doubled in 2002, to \$4.9 billion, and is on track to rise 24% this year. The stock, recently at \$43.82, has returned investors 40% since the merger.

Now Thompson is trying to work his magic again. But this time he's flying in the face of industry convention. His recently closed deal to merge Wachovia's brokerage business with that of Prudential Financial Inc. adds Pru's 4,400



CEO THOMPSON MAY SOON HAVE THE NO. 3 U.S. BROKERAGE

retail brokers to Wachovia's own mulling brokerage operation. The deal comes at a time when many big brokerages are thinning their sales ranks and fighting to get back into investment good graces after the spate of Wall Street scandals. What's more, the track record for big broker combinations is decidedly mixed. Think of American Express Co.'s failed acquisition of Lehman Brothers, or Credit Suisse First Boston's struggles with onetime hotshot Donaldson, Lufkin & Jenrette.

Thompson thinks he can beat the odds. For one, he is betting that Wall Street's doldrums are over. "This country is a stock-buying country," he reasons. He also thinks that the Pru deal gives Wachovia to benefit from the huge wealth transfer to baby boomers from their aging parents. "Trillions of dollars are going to change hands, and the brokerage industry is going to be a tollgate. I like our odds." Like the Wachovia takeover, Thompson's deal for a piece of the rock promises a big return on a relatively small outlay. It gives Thompson a coast-to-coast work force of 12,000 brokers to peddle mortgages, car loans, and other con-

The plan? Merge back offices, close overlapping branches, and aim to double the share of profits from the brokerage business to 10%. Some investors foresee little risk because even if the market tanks—an increasingly unlikely prospect—Wachovia has a relatively small investment in the deal. "The downside risk is very small, and the upside is tremendous, particularly if you believe the bear market is over," says Thomas K. Brown, chief executive of Second Curve Capital LLC, a New York hedge fund that owns Wachovia shares.

For its part, Prudential, long dogged by internal conflict between its stock and insurance sales forces, was happy to

tight cost controls—with Prudential's mostly urban sales force, whose average compensation is much higher than Wachovia's brokers. The average Wachovia broker has \$44.5 million in client assets, vs. \$55 million at Prudential. "Any time you try to merge two distinctive cultures like that, it's a real challenge," says Paul E. Purcell, chief executive of Robert W. Baird & Co., a Milwaukee-based securities firm.

To try and forestall an exodus of Pru brokers, Wachovia is giving them retention bonuses. It is also taking the unusual step of providing retention bonuses for the brokers' assistants. In fact, while it will not disclose numbers, Wachovia says it has offered far more in bonuses for the Pru deal than it did for all employees in the much larger First Union-Wachovia merger. With Wachovia generating \$2.5 billion in excess capital annually, the bank can afford it.

Yet UBS PaineWebber says that it has already lured away several Prudential branch managers in the Northeast and Midwest, and industry analysts say Merrill Lynch has done so as well. Moreover, with many of the Prudential brokers grumbling over retention packages that are lavish for the highest producers but skimpy for everybody else, Pru's rank-and-file sales people also could soon be headed for the door. Wachovia notes that the attrition rate for Pru's top-producing brokers has actually dropped from an annualized 8%-to-10% rate before the merger to 6.5%—thanks to the retention bonuses offered them and their assistants. "We are very pleased with where we are right now. We're not seeing any mass exodus," Donald A. McMullen Jr., president of Wachovia's Capital Management Group, told analysts in July.

Although Wachovia has \$350 billion in assets, its relatively small investment banking operation never had the hot initial public offerings and wide array of financial products that attracted upscale investors to its larger competitors. With the market shaking off the bear, however, the company says it's ready with new products. In recent months, it has also won more underwriting deals in such niches as real estate investment trusts.

Thompson has made a bold gamble, going deeper into the brokerage business just as most of Wall Street is retrenching. Like any shrewd investor, he hopes that he bought at the bottom of the market. Many an investor has tried that same strategy—only to get burned. But Thompson knows that the ones who time it right have no regrets.

By Dean Foust in Charlotte, N.C., with Brian Grow in Orlando and Emily Thornton in New York

WACHOVIA'S DRIVE INTO THE BROKERAGE BUSINESS



■ **1985** Ed Crutchfield is named CEO of sleepy, southern First Union. He goes on to snap up more than 75 banks, transforming it into a banking behemoth.

■ **1998** First Union makes its first big foray into the securities business, buying Richmond (Va.)-based Wheat First Butcher Singer for \$491 million. It also pays \$2.1 billion for the Money Store, a subprime lender known by its pitchman, ex-New York Yankee Phil Rizzuto. ▶

■ **2000** Crutchfield, diagnosed with lymphoma, resigns as CEO. First Union veteran G. Kennedy Thompson succeeds him.

■ **2000** Thompson closes the Money Store—with a \$2.8 billion write-off—and focuses on asset management, investment banking, and consumer banking.

■ **2001** Thompson strikes a \$14 billion deal to acquire the struggling Wachovia, trumping a hostile bid from SunTrust Banks. The new institution takes the Wachovia name.

■ **JULY 2003** Wachovia combines its brokerage force with Prudential's.



er-banking products as well as securities. In terms of pure heft, Wachovia's securities trails only Merrill Lynch and Mon Smith Barney and runs neck-and-neck with Morgan Stanley. And by capturing the stealth takeover as a joint venture—in which Wachovia maintains 62% ownership, management control and an option to buy Prudential's stake in the future—Thompson's deal is a national brokerage force for the nation's fifth-largest bank for only about \$1 billion in up-front integration costs.

cede control of its unprofitable brokerage business to Thompson because of the increased scale and efficiencies that will result from the deal. "We'd rather own 38% of No. 3 than 100% of No. 10," says John R. Strangfeld Jr., vice-chairman of Prudential Financial.

Still, Thompson is taking on some serious management challenges. The First Union-Wachovia merger involved combining two like-minded Southeastern banks. Now, though, he must mesh his small-market brokerage—known for its

COMMENTARY

By Jennifer Merritt

JOBS ARE SCARCE. B-SCHOOLS SHOULD GET USED TO IT

When Jean Eisel began working in MBA career services a decade ago, finding jobs for grads was a cinch. The best B-schools could simply hang out their shingles and, like magic, employers would show up. There was a time-honored pattern: Second-year students were interviewed during the fall, and by November or December, they were fielding job offers. The major employers of MBAs—investment banks, consulting firms, and

ing far fewer MBAs when they do come to campus—and often not until spring. Most employers have cut back on the number of campuses they visit, their winter offers continue to dwindle, and many say they'll be looking to after-graduation cherry-picking and spring job postings to fill their yet-unknown 2004 needs. The new reality for career-service staffers and students alike is stark: Companies are now hiring on a just-in-time basis.

getting small-fry outfits in industry, although of course the brand-name school will continue to cater to the big boys of Corporate America. Staffers at schools like University of Southern California's Marshall School of Business are now showing up at recruiters' doors to keep up with their latest hiring moves.

B-schools should also consider shifting the bulk of recruiting to the spring, when companies have a better idea of their third- and fourth-

quarter staffing needs. Smaller companies are even less likely to hire in December for August jobs. But they might be more inclined to make job offers if spring becomes the new hiring season. And by the spring semester, students will likely have better, more well-researched career plans.

Just as important, B-schools will need to continue to hammer the job-market reality home to their students, who will still expect an offer as a



HARSHER HIRING

▶ Fewer recruiters showing up for campus interviews in the fall

▶ More just-in-time hiring in spring and summer

▶ Consulting and banking jobs are still down by half

Data: BusinessWeek

consumer-goods companies—hired hordes of students in the winter to start work the next August.

Now, as career-services director at Duke University's Fuqua School of Business, Eisel has found herself—and the MBA grads she's trying desperately to place—in the middle of a prolonged job drought. Try as she might to boost the numbers, Eisel still hasn't found spots for about 30% of last year's graduates. Although she and other B-school administrators realize the boom days are gone and have scrambled to scrounge up job possibilities for grads, many still insist on relying on fall recruiting, hoping that things will get back to "normal" soon.

But Eisel and her counterparts may be facing a permanently changed recruiting landscape. In today's world, employers are showing up less and less in the fall and hir-

This recruiting revolution has widespread repercussions for B-schools, which have long relied on the steady cycle of fall recruiting to place the bulk of students. To cope with the leaner, meaner job scene, B-school career offices will have to take on new and different responsibilities. First, abandon the hope that MBA recruiting will go back to the shingle-hanging days. That means reaching out even more to nontraditional and smaller recruiters—employers that might be hiring only one, two, or three MBAs, instead of the 200 or so each consulting firm or investment bank once scooped up.

Some schools have already begun to regroup, like the University of Pennsylvania's Wharton School, where seven new staffers have joined the career-service office this year. Most are responsible for tar-

sign of an immediate return on their sky-high tuition investment. That means more career counseling and preparation for students and lessons in managing too-optimistic expectations. Now, "every search is nontraditional, and every search is unique," says Steven D. Lubrano, assistant dean at Dartmouth College's Tuck School of Business.

Above all, B-schools should stop envisioning a future in which companies come calling in droves. Even if it happens down the road, counting on such a rosy picture could lead to complacency. For B-schools, it's time to take those just-in-time case studies out of the classroom and apply them to the recruiting scene changing right under their noses.

Merritt writes about management education from New York.

FALL 2003 UNDERGRADUATE REVIEW

A GUIDE TO FEATURED BUSINESS DEGREE PROGRAMS

UNIVERSITY OF SOUTHERN CALIFORNIA, MARSHALL SCHOOL OF BUSINESS

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USC is the only top-ranked research university in the Western United States offering an undergraduate degree in business. The university's commitment to excellence in undergraduate education earned USC the *Time/Princeton Review's* "College of the Year" award in 2000. The 2001 "How to Get Into College" *Newsweek/Time* guide chose USC as one of America's nine "hottest schools," and the AAC&U named it a "Leadership Institution" in undergraduate education.

USC's Marshall School of Business is one of the few business schools that combines a diversity of students, world-class research and scholarship, and excellence in business education. Undergraduate core requirements provide students with a comprehensive intellectual foundation and Marshall students have complete access to the rich variety of courses and minors offered across USC. Located in Los Angeles, one of the world's most diverse cities and gateway to the Pacific Rim, Marshall is dedicated to strengthening its position as a global center of business education. The university also maintains one of the largest, most supportive alumni networks in the world.



The center of campus, Doheny Library is a masterpiece of architecture and interior design.



Business Degree Program

2002 *U.S. News & World Report* ranked Marshall's undergraduate program as #11. Students pursuing a degree in Business Administration or Accounting combine in-depth knowledge of theory, real-world practical learning in business, and a solid foundation in the liberal arts and sciences. This preparation uniquely equips graduates to deal with a rapidly changing, complex world. Focusing on leadership development and the acquisition of managerial skills, Marshall emphasizes communication, analytical decision making and teamwork. Exchange programs give exposure to the multicultural nature of global business. The integration of broad-based business knowledge and an area of expertise prepares students for productive careers or for undertaking advanced professional studies.



UNIVERSITY OF
SOUTHERN CALIFORNIA

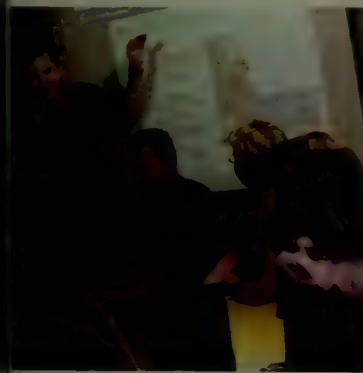
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Motivated students learn side by side with renowned faculty, gaining hands-on research experience. They are challenged by rich discussions, leadership responsibilities, internships, and study abroad opportunities. They also benefit from an intellectually stimulating environment, interaction with achieving classmates, and campus community dedicated to their success.

Graduates in many fields are considered the best prepared in the state and are recruited by Fortune 500 employers.

WSU offers many of the Northwest's top and unique undergraduate programs, and provides graduate studies in 70 fields. The Master of Business Administration and the Ph.D. in Management Information Systems are among the best in the College of Business and Economics.



Len Jessup champions cutting-edge technology, as used in this electronic classroom.



Business Degree Program

Contemporary and technology-infused courses, faculty student research partnerships, and internship and placement emphases are a few of the reasons it's "not business as usual" for WSU College of Business and Economics' students.

For example, seniors in a Finance class manage a \$1 million portfolio of WSU funds; last year they beat the market again and were interviewed on CNBC. Students in Hospitality log 1,000 paid internship hours, run on-campus businesses, and choose from top job offers. And, the new "Boeing Wireless Classroom of the Future" provides a high-tech environment where student teams collaborate and videoconference with executives from around the world.

With more than a century of experience educating tomorrow's leaders, students are encouraged to experience innovation, assume leadership, and develop an entrepreneurial outlook in every aspect of their lives and futures.



World Class. Face to Face.

SAN DIEGO STATE UNIVERSITY

San Diego State University is the oldest and largest higher education institution in the San Diego region. Its diverse student body benefits from innovative educational programs distinguished by a growing emphasis on global education. This year SDSU was profiled by the Association of International Educators (NAFSA) and the

U.S. State Department's Bureau of Educational and Cultural Affairs as one of six U.S. higher education institutions that serve as models for internationalization.

SDSU also aims to be an engaged university that can help address the social, entrepreneurial and workforce needs of San Diego and beyond. In recent years the university has created or expanded degree programs that provide industries such as hospitality and tourism, health care, biotechnology, and construction management with highly skilled professionals.

The university is designated a "Doctoral/Research University-Intensive" by the Carnegie Foundation, which places it among the top seven percent of more than 3,800 higher education institutions conducting research in the U.S.



San Diego, CA • 619-594-5259 • www.sdsu.edu/business



Business Degree Program

One of the largest undergraduate business programs in the country, the SDSU College of Business has earned national acclaim for many of its programs, including undergraduate International Business and graduate Entrepreneurship, which rank among the top programs in the country. Also offered are Accounting, Finance, Financial Services, Hospitality and Tourism Management, Information Systems, Management, Marketing, and Real Estate. Both the College of Business and the School of Accountancy are accredited by AACSB International, the premier accrediting agency for management education.

SAN DIEGO STATE UNIVERSITY

THE UNIVERSITY OF OKLAHOMA

OU provides a major university experience in a private college atmosphere.

It has 20,000 undergraduate students enrolled on the Norman campus. Located 20 miles from Oklahoma City, it is part of a metropolitan area that is home to 900,000 people. OU is beautifully landscaped with easy access to research and support facilities, shopping, transportation, and recreational activities.

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Construction has begun on Michael F. Price Hall, a 55,000-square-foot addition to Adams Hall

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- Internships with U.S. and international corporations





MARYLHURST UNIVERSITY

Marylhurst programs are structured around flexible options. Online courses are available 24 hours a day. Campus classes run evenings, and weekends. Degree programs can be customized to meet professional goals. Instruction is year-round.

Classes are small and seminar-style to facilitate discussion. The Marylhurst faculty is comprised of practicing professionals, recruited in their fields — teachers, managers, marketers and entrepreneurs. Each brings practical, tested experience to the classroom.

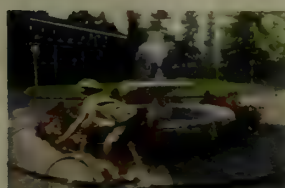
Many students take full advantage of their learning at work from life by earning up to 12 credits (two years) through prior learning assessment programs and proficiency exams. Coursework completed long ago



may be transferable. Military service credit may also be transferred.

When an employer reimburses tuition and fees at the end of the term, Marylhurst defers these costs. Scholarships and financial aid packages are available for all ages.

Portland, OR • 800.634.9982 • www.marylhurst.edu/business



Business Degree Program

Marylhurst accommodates professional responsibilities and business travel, allowing business students to complete a degree at their own pace.

The BS in Business and Management can be earned completely online in an interactive team environment featuring case-based coursework. Other online disciplines include Real Estate and Organizational Communication. Public Relations is one of six professional certificates. A strong on-campus program is available as well.

Founded in 1893, Marylhurst is a leader in innovation and academic excellence. This extraordinary learning environment, along with a liberal arts education, prepares Marylhurst graduates to meet the critical analysis and business skills corporate managers demand.

Marylhurst University is ranked a "Best Value" by *US News & World Report* 2003, and is accredited by the International Assembly for Collegiate Business Education.

MARYLHURST UNIVERSITY

MEXICO STATE UNIVERSITY

The main campus of NMSU is located in Las Cruces, a city of about 85,000, and is within an hour's drive of El Paso, Texas, and Juarez, Mexico. The region features desert mesas, the farms of the Rio Grande Valley and vistas of the Organ Mountains. Hiking and camping are available in the Organ Mountains National Monument Wilderness area of Southern New Mexico and skiing can be enjoyed in Ruidoso and Taos about two hours away. The university offers a mix of southwestern culture and tradi-

tions and strong undergraduate programs within a major research university. About 49 percent of the 15,000 students are minorities and about 2,700 are graduate students. Students will find the university's faculty members, many of whom are recipients of teaching awards, to be accessible inside and outside the classroom.

NMSU is in the Sun Belt Conference, NCAA Division I-A, and is the home of the American Southwest Theatre Company.

Las Cruces, NM • 505.646.4329 • www.nmsu.edu

Business Degree Program

The College of Business Administration and Economics begins its fortieth year with new leadership as well as newly affirmed accreditation by AACSB International. Dean Garrey Carruthers has served as governor of New Mexico, a federal government official and a health insurance executive. Now he is positioning the college to play a significant role in economic and business development in the state and region.

Students in the college are able to participate in a variety of student business organizations, some of which have been recognized nationally. In addition, students are encouraged to take advantage of co-op and internship opportunities as well as international programs in Latin America, Europe and Asia.

The college offers an array of undergraduate majors. Special features include the professional golf management program, courses in public utility regulation, and core courses integrating major business disciplines.



FALL 2003 UNDERGRADUATE REVIEW

A GUIDE TO FEATURED BUSINESS DEGREE PROGRAMS

SAINT MARY'S COLLEGE OF CALIFORNIA

Saint Mary's College of California, founded in 1863, is one of the oldest colleges in the West. It is a private coeducational college, owned by the Lasallian Christian Brothers, whose teaching traditions date back to 17th century France. It prides itself on its high academic and personal standards, open intellectual atmosphere, and dedication to the traditions of the liberal arts. Its faculty

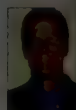
includes highly regarded teacher-scholars with earned doctorates from leading universities. Small class size, and individual attention given to students allow for a rich educational experience, as recently verified by its excellent ratings in the National Survey of Student Engagement. The 420-acre campus is located in the picturesque Moraga Valley, 20 miles east of San Francisco.



Moraga, CA • 925.631.4000 • www.stmarys-ca

Business Degree Program

The School of Economics and Business Administration offers comprehensive undergraduate degrees in Accounting (B.S.), Business Administration (B.S.), and Economics (B.S. and B.A.). Graduates display strong communication skills, and the confidence and ability to address both technical and human dimensions of business and organizational life. Some graduates enroll in the School's esteemed MBA and Executive MBA programs.



Roy Allen, Dean
Professor, School of
Economics and Business
Administration

A recently launched "Center for the Study of Fiduciary Capitalism" supports the study of business ethics and corporate governance.

A new executive education program engages students with senior executives from Dolby, Lucasfilms, Apple, H.P., Cisco, and others. Extensive internship, peer mentoring, and study abroad programs are available. The School has one of the most extensive alumni networks in Silicon Valley and the San Francisco Bay Area.



SAINT MARY'S COLLEGE
of California

CHAPMAN UNIVERSITY

In Orange County, there is a premier center of higher education where students receive an education that is broad and deep and faculty take their roles as educators and mentors seriously. Currently home to more than 4,500 students pursuing a wide array of undergraduate and graduate degrees, Chapman University remains squarely focused on its mission—to provide personalized education of distinction that leads to inquiring, ethical, and productive lives as global citizens.



Chapman continues its dramatic advance on all fronts—in program offerings, campus and career resources, and the caliber of its students and faculty. Its renowned business, law, and film and television schools offer the highest quality professional training both inside and outside the classroom. Newly constructed state-of-the-art business and law buildings will soon be joined on the park-like campus by a new film and television studio, a 100,000-square-foot library, an all-faiths chapel, a major addition to the music building, and a modern new residence hall. And students' average SAT scores have risen year after year since 1991. It's no wonder that *U.S. News & World Report*, *Barron's Profiles of American Colleges*, *The Templeton Guide* and *Yahoo!* have all recognized Chapman as one of the strongest universities in the West and the nation.

Orange, CA • 714.997.2400 • www.chapman.edu

Business Degree Program

As one of the world's select business schools accredited by AACSB, the George L. Argyros School of Business & Economics offers bachelor's degrees in business, economics and accounting as well as the MBA and Executive MBA.

At the Argyros School, curricular and non-curricular opportunities abound. Undergraduates may pursue an emphasis in finance, marketing, business economics, management, entrepreneurship or international business depending on their chosen career path. Internship opportunities are extensive, providing complement to coursework by giving students a practical perspective. And numerous prominent speakers such as Nobel prizewinning economist Milton Friedman, high-profile CEO international leaders in business and government, and three modern presidents have visited the campus to share their perspective.

The philosophy of the School emphasizes the principle that managers must think creatively, behave proactively and communicate effectively to create and enhance value.

The closer you look, the better we look.



COLORADO STATE UNIVERSITY

Fort Collins, CO • 970.491.1101 • www.colostate.edu

tuated at the foot of Rocky Mountains, Colorado State University is a world class research institution that puts students first by providing them with a welcoming environment, a tradition of excellence, and a commitment to their future.

Colorado State you'll find an environment that encourages students to become whatever you set your mind to be.

Colorado State University is consistently rated as one of the

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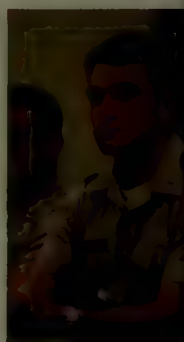
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WHO SAYS CEOs CAN'T FIND INNER PEACE?

Salesforce.com's Benioff brings spirituality to the job of selling software as a service

On June 3, Marc Benioff, the affable CEO of Net startup Salesforce.com Inc., was playing host to 400 customers, business partners and journalists at the Grand Ha-Room, a tony cigar bar on the top of a midtown Manhattan skyscraper. The occasion: a press conference introducing the company's newest technology. Dressed in a dark suit with a silver-present "End of Software" button on his left lapel, Benioff was wooing guests when he got a call on his cell phone from a representative of Arnold Schwarzenegger. Would he buy a ticket to a charity screening on June 27 of the actor's new movie, *Terminator 3: Rise of the Machines*? Benioff's brain was planning on introducing an update of Salesforce.com's Web-based customer-management software at about the same time anyway. Why not become the primary sponsor of the event, invite hundreds of business associates to the screening, and grab attention for his product—all in one swoop? This came together in a matter of seconds. In the end, he hosted 600 guests at San Francisco's Galaxy Theater and then whisked away customers and prospects—Arnold Schwarzenegger—to a private dinner nearby. This seems like a jarring mix of dot-com-era excess and post-style do-goodism, well, so it is. Benioff, 38, a former Oracle Corp. executive, has fashioned an environment at Salesforce.com where a relentless, win-at-all-costs drive is balanced with an eclectic blend of Eastern spirituality, parties, and charity. He believes that mixing these personal interests with the best traditional business practices is an "integrated" company where people escape the traps of conventional thinking and operate more creatively. "We need constant reinforcement that

we're a different sort of company with a different set of values," he says.

What's so different about Salesforce.com? The San Francisco company is threatening giants such as Siebel Systems, Oracle, and PeopleSoft with a new way of delivering the software corporations use to manage their businesses. Rather than hawking multimillion-dollar packages that sometimes take more than a year to install, Salesforce.com sells software as a service delivered via the Internet. Corporations typically pay \$65 per month for

each user, and they don't have to worry about the headaches of buying and maintaining their own computers and software. Although customer-management leader Siebel Systems Inc. denies Salesforce.com is a threat, the upstart is gaining customers fast, with a total of 6,900. SunGard Data Systems Inc., for instance, just agreed to use the service for 1,000 salespeople worldwide. "We don't have an appetite to pay \$18,000 a head and spend years installing software," explains Bettina A. Slusar, senior vice-president of glob-

Salesforce.com's revenues are rocketing, and it's in the black—making it a target for bigger software companies. Benioff meditates to cope with the stress



WORKMATES:
Benioff
with his
dog, Koa

al account management for SunGard.

The upshot is that Salesforce.com has emerged as one of the few bona fide successes among dot-coms born in the late 1990s. In the quarter ended July 31, the four-year-old private company recorded revenues of \$21.6 million, double a year earlier, and logged a \$127,000 profit, its second sequential quarterly profit. New requests for service grew so rapidly this summer that Benioff plans on boosting his staff of 400 by 20 to 25 people per month for the rest of the year, double the previous rate. Meanwhile, Siebel Systems saw its revenues decline 17.8% last quarter and is cutting staff. Benioff rubbed it in by sending recruiting e-mails to Siebel Systems employees. He may be spiritual, but he's no saint.

Investment bankers are attracted to Salesforce.com like 14-year-old boys to Britney Spears. It's expected to deliver one of the hot initial public offerings of 2004. "This is a company that will attract plenty of attention," says Evan M. Newmark, global head of technology banking at UBS Investment Bank, who is angling for a piece of the action. "Like Dell on the hardware side, they're a disruptive business model."

Benioff faces a host of challenges as he tries to turn Salesforce.com into the next Dell. Traditional enterprise software makers are gunning for him like never before, and rivals such as UpShot Corp. are also delivering software over the Net. If that's not enough, software giant Microsoft Corp. is targeting one of its sweet spots: small to medium-size companies. Critics question whether Benioff's off-beat management ideas can succeed as his company becomes more complex and operates with a bull's-eye on its back. "I find it hard to believe that Marc is doing a good job as CEO," says John Dillon, head of software maker Navis LLC, who was Salesforce.com's CEO until he and Benioff had a falling-out in 2001. "He's not

operational. He doesn't have the wherewithal to manage people."

While that may have been true a couple of years ago, Benioff seems to have come into his own as a manager since then. He has recruited a handful of tech industry veterans, including Jim Steele, a former IBMer who runs worldwide sales, and Steve Cakebread, who left his chief financial officer post at software maker Autodesk Inc. to become CFO. Meantime, Benioff concentrates on his strengths—strategy and marketing. His unorthodox management style has helped turn Salesforce.com into a force to be reckoned with. While it's still a fraction of the size of the giants, it is they who are under pressure to respond to the hotshot upstart.

Benioff has a long history of swimming against the current. While his par-

ents were busy running a women's clothing store south of San Francisco, other kids were absorbed in sports, teenage son programmed games on Commodore 64 computer and created a business selling the computer game. When his classmates at the University of Southern California were choosing majors, he was already dreaming about the mark he would make on the tech industry. He chose Oracle for his first job in 1986 because it was an industry leader. Yet ultimately, Oracle was frustrating. During Benioff's 13 years there, he always stood on the company's fringe, running small PC- and Internet-related businesses, few of which flourished. Internet seemed to offer the path to transforming the industry, but he was sure what role he should play.

The result was a three-year quest

personal and professional fulfillment that shaped the quirky Marc Benioff of today. He took a leave from Oracle in 1996 and rented a house in Hawaii, where he swam with dolphins and dreamed of launching a business that would compete for corporate computing. Amazon.com Inc. did for e-commerce what he did for e-summers. Then he traveled to India with friend Arjun Gupta, seeking both enlightenment and career direction. One of the gurus they met was Mata Amritanandamayi, who urged them to give back to the world even as they pursued their ambitions—advice Benioff took to heart. "Spirituality and technology are the yin and yang of Marc," says Gupta, now a venture capitalist. "Most people make their lives their religion. Marc does both—together." Back at Oracle, Benioff helped Lawrence J. Ellison set up a charitable foundation and plowed into new Internet projects.

It was the winter of 1999 when he left Oracle to start his own company. Finally, Benioff had a chance to create an organization based on the ideas he had pulled together during his long Oracle internship—melding Internet technology, the software service business model, philanthropy. From the start, Benioff decided that 1% of the company's stock, 1% of its profits, and 1% of emp-

MARC RUSSELL BENIOFF

BORN Sept. 25, 1964, in San Francisco.

UPBRINGING Parents Russell and Joelle Benioff owned Stuart's, a woman's clothing store south of San Francisco.

EDUCATION B.S. in Business Administration from University of Southern California, 1986.

CAREER Thirteen years at Oracle, the software powerhouse, as a salesman and later manager of PC- and Web-related businesses. He started Salesforce.com with three co-founders in February, 1999, and planned on being a hands-off chairman. But Benioff became CEO in November, 2001, after a falling-out with tech veteran John Dillon, who had been hired to run the company.

HIS VISION The end of software as we know it. He believes that eventually most corporations will buy software as a service delivered via the Internet, the way Salesforce.com sells its software for customer-relationship management.

HOW HE GOT RICH His Oracle stock options yielded more than \$40 million, and a \$50,000 ground-floor investment in Siebel Systems in 1993 produced more than \$20 million in gains when he cashed out in 1999.

HOME LIFE He lives with girlfriend, Lynne Krillich, in San Francisco and Hawaii, where they swim with dolphins.

HOW HE STAYS CALM Although Benioff is Jewish, he's interested in many religions, especially Eastern ones. He meditates, practices yoga, and has met with the Dalai Lama.

LITTLE-KNOWN SKILL As a temporary sheriff, he can marry people. He has officiated at three weddings.



PRE-ORACLE: Benioff the boy



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ees' time would go to charity. He calls it "compassionate capitalism."

No way is Benioff your conventional boss. He frequently shows up at work in a Hawaiian shirt with his golden retriever, Koa (the company's "Chief Love Officer"), at his side. He has taken many of his managers swimming with the dolphins near his second home in Hawaii. At 6-foot-5, with longish brown hair and a ready smile, he comes off like an overgrown, happy-go-lucky kid. How does he stay so calm? "He meditates. He doesn't put stress on himself," explains Benioff friend Robert Thurman, a religion professor at Columbia University.

His zenlike approach to life even permeates the elaborate management process he uses to run Salesforce.com. It's called V2MOM—standing for vision, values, methods, obstacles, and measurement. It's about laying out a broad strategy, getting all the employees to agree on goals and methods, anticipating problems, evaluating tactics, and measuring results. Any new initiative is put to the V2MOM test. "It gets tiresome, with the endless iterations we seem to go through," says Chief Technical Officer David Moellenhoff. "But when we come to a consensus, it's enlightening. You really do make a breakthrough." This year's master plan gobbled up 100 hours of executive meetings.

Marketing extravaganzas are another essential part of the company's success. Early on, Benioff cut way back on traditional advertising in favor of what he calls "relationship marketing." By inviting employees, customers, potential customers, and the press to high-profile events, he spreads good feelings about his company and exposes prospects to satisfied customers. Not only does the company round up leads at these events but it also receives scads of favorable press coverage. Even Keith Raffel, chairman of rival UpShot, admits: "We're drafting on their marketing machine." On Sept. 5, Benioff plans on hosting 600 customers, prospects, and journalists at his "100,000 Enlightened Users" event in San Francisco—starting with an appearance by the Dalai Lama and concluding with a party celebrating the company reaching the 100,000-user mark. "The key to our growth is you have to get these messages out there," says Benioff. "It all comes back to our financial success—otherwise we don't do it."

Meet with the Dalai Lama? Swim with the dolphins? It's business as usual, Marc Benioff-style. And if he keeps it up, enterprise software may never be the same.

By Steve Hamm in New York

EARNINGS

A NASTY SURPRISE FROM HP

Its PC unit is in the red again after six months of profitability

Hewlett-Packard Co. execs have insisted all year that the company is fast rivaling Dell Inc.'s ultra-efficient, low-cost model for selling computers. But on Aug. 19, some gaping holes were poked in this sanguine claim.

Just five days after Dell nailed expectations for its quarterly numbers, HP baffled Wall Street. Its fiscal third-quarter results of \$297 million in net income

and \$17.3 billion in sales whiffed analyst estimates on both counts, driving HP's shares down 10%, to \$19.80. The company stumbled in setting prices too low, particularly in the personal-computer business, and miscalculating demand, both areas where Dell has executed. Result: HP's personal-systems division, including PCs, posted an operating loss of \$56 million after breaking into the black six months prior. HP "should have done better," says CEO Carleton S. Fiorina.

Competitive pressure in computers is only going to get more intense. While Fiorina promised in an Aug. 19 conference call to be less aggressive in PC pricing to bolster margins, Dell the next day announced a broad swath of price cuts as large as 22% on PCs and servers. The unspoken taunt is clear: Dell believes it can operate profitably at levels HP can't. "HP had an opportunity to take advantage of competitors in PCs but ended up doing damage to itself," says analyst Laura Conigliaro of Goldman, Sachs & Co.

That damage isn't just to the bottom line. Analysts also were troubled by HP's inability to manage Wall Street's expectations. In an era where tech companies typically set conservative fi-

nancial guidance and then make sure to deliver those numbers, HP clipped credibility. The company's \$100 million top-line miss on analyst estimates, especially startling. HP hadn't provided third-quarter projections, but it said it was comfortable with analyst projections for the second half. Now the company acknowledges that it fell short of those numbers. "It

generally lackluster," says Bear, Stearns Co. analyst Andrew Neff. "We want to see some consistency."

To deliver steady results, HP will have to solve its execution issues. One key problem was its overly aggressive pricing in desktops, where it sought to undercut Dell. V component prices falling as expected, HP tied to longer-term deals with retailers and resellers, its margins were squeezed. While Dell has more flexibility because of its largely direct-sales model, HP promised that it will continue to ratchet up its direct business. HP also underestimated demand for flat-panel displays and was forced to

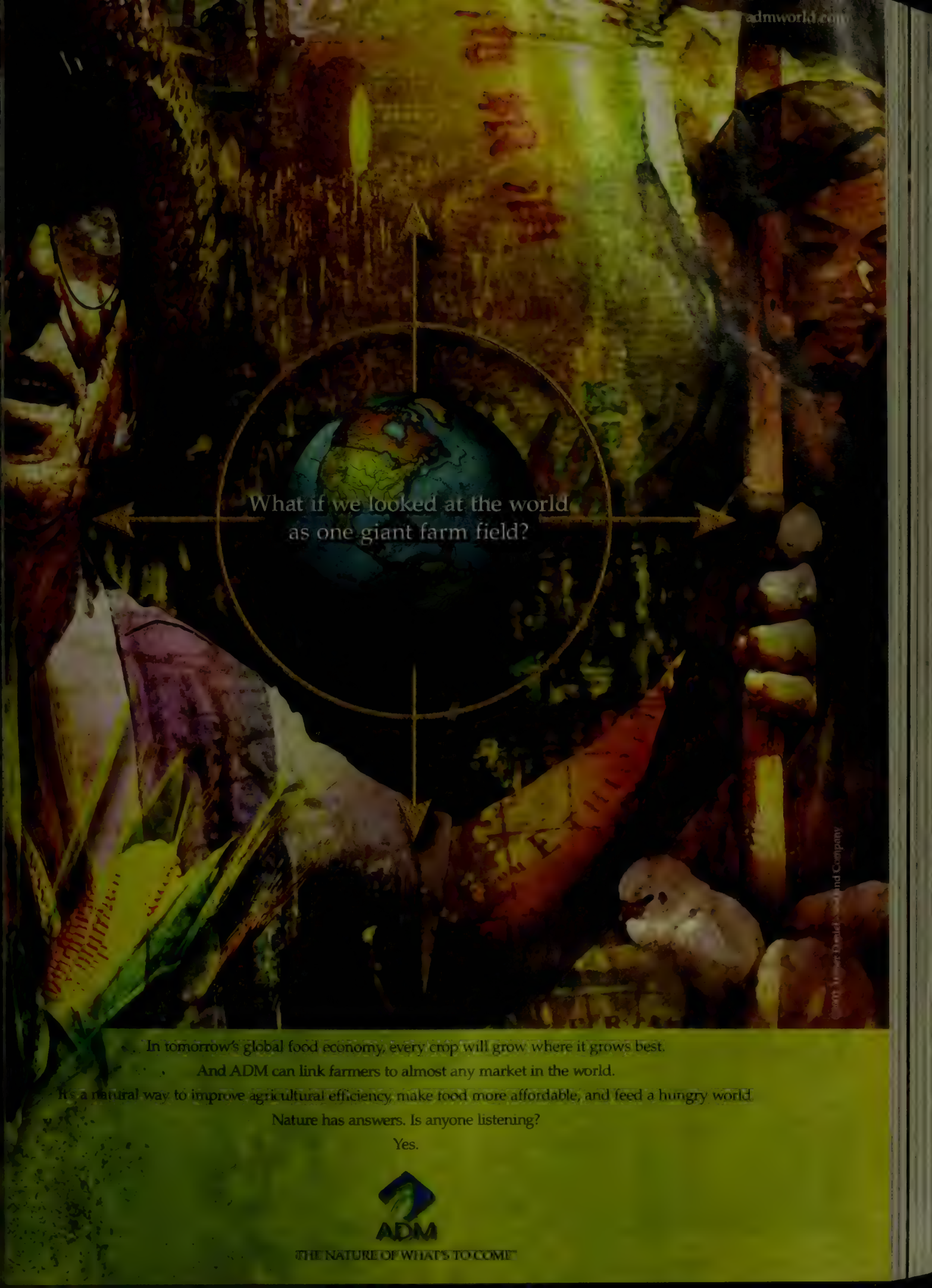


CEO Fiorina said HP's PC prices were too aggressive. The next day, Dell slashed its prices

freight in parts at a much greater cost.

Certainly, some of the company's struggles are seasonal. Its European and consumer operations—areas that are more significant to HP than Dell's—generally fade during HP's fiscal third quarter and pick up steam in its fourth. "Some of our drawbacks in the third quarter can be huge advantages in the fourth quarter," says Jeff Clarke, HP's executive vice-president for global operations. But HP has some cleanup to do before it can capitalize on any such benefits.

By Ben Elgin in San Mateo, Calif.



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INVESTING

ON A WING AND A PRAYER

Investors flock to stocks of companies in Chapter 11—and they usually get burned

For a brief moment, it looked as if Enron Corp. might make daring investors rich again. On July 11, the once-high-flying energy trader filed its bankruptcy reorganization plan. In the next four days, the stock shot up 70%, to 8.2¢, as volume spiked to 13.8 million shares a day, eight times its average. Go-go postings popped up on Internet message boards, urging everyone to hurry and buy shares.

Offering the opposite view, though, were other messages warning would-be purchasers to steer clear. They noted that, under Enron's plan, its equity would disappear, as company executives all along have said. In a posting on Lycos Inc.'s Raging Bull Web site, buzzbee20 cautioned: "I got out today. Lost a bundle but not all. My advice, my friend—get out and stay out." Sure enough, Enron stock began slipping a week later and now sells once again for 5¢ a share.

These days, investors are spoiled for choice when it comes to bankrupt companies. After a three-year explosion of corporate failures, more than 400 public companies are now in Chapter 11, figures PricewaterhouseCoopers LLC—an all-time record. Included are many big,

familiar names such as insurer Conseco Inc. and airline UAL Corp. Indeed, eight of the 12 largest bankruptcy filings in U.S. history, measured by assets, are now being sorted out in court—as the companies continue to trade in the so-called pink-sheet and bulletin-board markets. What's more, the shares often go for pocket change, so even a penny-a-share price rise can bring a market-beating return.

Very occasionally, stocks in tottering outfits do maintain at least some value when the companies exit bankruptcy. But the harsh reality is that, in almost every reorganization, what money companies can scrape together goes to creditors first, often in the form of new equity, leaving old shareholders empty-handed. "If you purchase stock in a bankrupt company, it is highly likely that your investment not only will not rise in value, but that you'll be holding worthless shares," says Susan F.

Wyderko, director of investor education and assistance at the Securities & Exchange Commission.

So why do people still buy? One son is the temptation of a quick held out on Internet message boards and in spam. Some companies in Chapter 11 even push their own stock, as U-Haul International Inc. paid Amerco. And because these stocks are volatile, investors can score well-timed buys. For example, shares in Mirant Corp., an electric-power wholesaler, rocketed 31% in two days of trading, to close at 42¢ on Aug.

Besides, many investors believe the companies can turn themselves around, so they figure the stocks may be a good investment. Even when lawyers or the companies warn that day's shares will be voided, many investors simply choose to ignore the warning. "These investors are so rebellious in nature that when the company says

get nothing, they think the company is lying to them," says Michael Weinstock of Quadrant Group, which manages \$600 million in distressed securities.

The SEC is seeing a sharp rise in complaints from shareholders who got wiped out in bankruptcy reorganizations. That's due in part to Kmart Corp. After filing for Chapter 11 protection in January 2002, the discount retailer announced on Apr. 22, 2003, that bankruptcy court had approved



FOOL'S GOLD?

The five biggest companies now in bankruptcy court still see lots of action in their stock

COMPANY	SHARE PRICE*	52-WEEK RANGE	AVG. DAILY VOLUME (MILLION)
MCI **	5¢	3¢-29¢	9.9
ENRON	5¢	4¢-28¢	1.5
CONSECO	2¢	2¢-7¢†	2.0
GLOBAL CROSSING	2¢	1¢-4¢	1.3
UAL	47¢	45¢-\$1.91†	4.0

*As of Aug. 19

**Formerly Worldcom

†Since Chapter 11 filing in December

Data: Bloomberg Financial Markets

reorganization. The next day, 133 million shares were traded, up from an average of 21 million, and in a matter of days the stock price doubled, to 12¢. On the New York Stock Exchange's Kmart message board, posters urged investors to hold onto their shares. "This could be a great opportunity!!" cheered dadgum. "I may just be a buyer here." But two weeks later, the shares lost their value as the Troy (Mich.) company emerged from Chapter 11 and ownership of the company was transferred to its creditors.

Now, as other big names prepare to emerge from Chapter 11 behind, SEC officials warn many more investors undoubtedly will find that they, too, have been left holding the bag. Conseco plans to emerge in September, and Enron, UAL, and WorldCom (now known as MCI) are planning to come out in the next months. Each has warned that its stock will be worthless, yet shares in Enron, for one, still fetch 47¢.

In rare cases, shareholders do get something. For instance, when Peregrine Systems Inc., a San Diego software company, emerged from bankruptcy on Aug. 7, its equity holders received a third of its new shares. Peregrine's chairman, Edward J. Shoen, has been telling shareholders they'll be rewarded when the Reno (Nev.) company reorganizes and pays off creditors in full. His assurances have helped Peregrine's shares nearly triple, to \$11.85 from \$4.08, when it filed for bankruptcy protection on June 20, after defaulting on a \$100 million bond repayment.

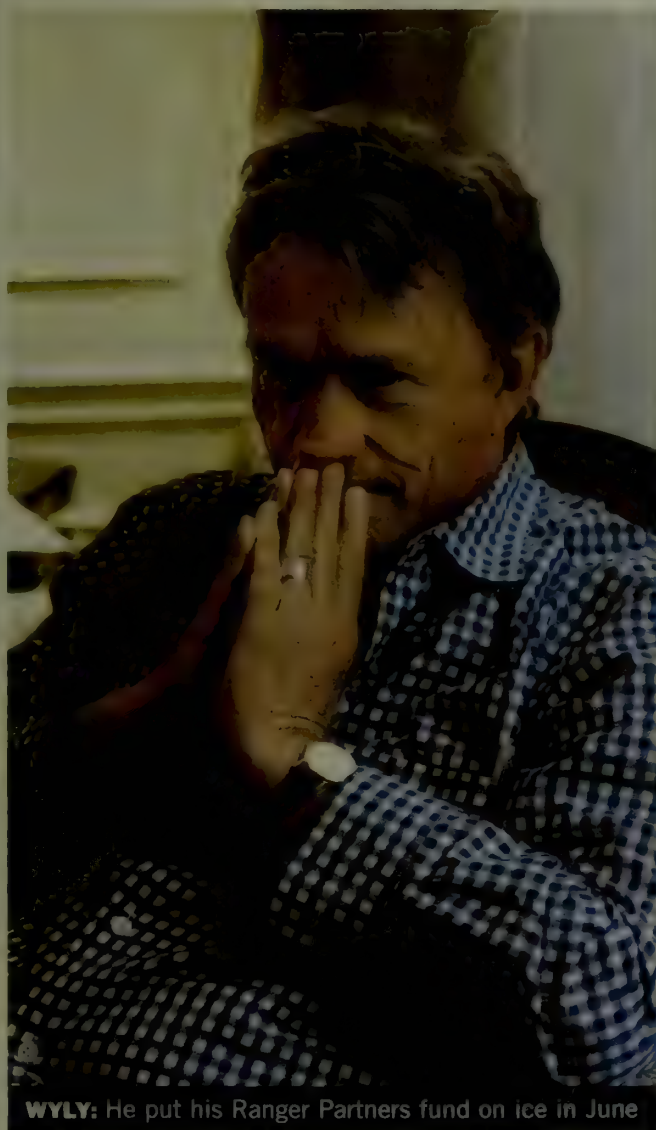
Shareholders in USG Corp. may fare better. The wallboard manufacturer rushed into Chapter 11 two years ago by a surge of asbestos-liability lawsuits, has said its equity owners could get out whole if Congress approves a fund that limits its hit. Indeed, shares in the Chicago company are still on the New York Stock Exchange, closed at \$15.48 on Aug. 19, up from \$3.88 when USG filed for bankruptcy in June, 2001. Already, DCI Capital Partners LP has made a bundle of USG. Douglas L. Dethy, a managing director of the New York contrarian investment firm, bought 2 million shares of USG at around \$6.10 apiece, and sold 1 million shares between Apr. 1 and Apr. 30 as the share price topped \$20. Dethy says most investors should have sold their shares in bankruptcy court. "To get money, things have to get substantially better, and that doesn't usually happen," he says. "The vast majority of these things don't work out." That's something to remember the next time some spammer is up pushing a Chapter 11 stock.

Michael Arndt in Chicago, with Der Hovanesian in New York

LITIGATION

SAM WYLY'S HEDGE-FUND FIASCO

Hiring a "family friend" brought lawsuits instead of fat returns



WYLY: He put his Ranger Partners fund on ice in June

It seemed like a match made in heaven. Billionaire Dallas investor Samuel E. Wyly would launch a group of hedge funds. Russell D. Glass, a protégé of legendary financier Carl C. Icahn, would join him to run at least one of them. Wyly had known the 41-year-old Glass—who went to Princeton University with his son Evan—for 20 years, and welcomed him to the business like the family friend he was.

The welcome mat didn't stay out for long. Last October, Wyly started Ranger Partners, a fund focusing on shareholder activism with Glass as the manager. By April, Glass had filed suit in Delaware against Wyly, charging breach

of contract and demanding at least \$200 million in damages. In June, Wyly fired back with a countersuit in Delaware charging that Glass mismanaged the fund and misrepresented his investment track record at Icahn's firm. Wyly filed a separate but similar complaint in Dallas seeking at least \$16 million in damages. Also in June, Wyly quietly put the fund on ice and paid investors back slightly less than what they had put in.

Through a spokesman, Glass and his attorneys declined to comment. In a statement, K. Scott Canon, president of Wyly's Ranger Capital Group, a limited partner of Ranger Partners, said: "The legal disagreements over these matters are just that—disagreements that will be addressed between the involved parties in an appropriate manner and at an appropriate time." Each side, however, does deny the other's allegations in its responses filed in court. It's unclear when and where a trial will take

place, if there's no settlement.

The dueling lawsuits offer a rare window into the secretive inner workings of a hedge fund. If Wyly's accusations turn out to be true, the case will also be a cautionary tale of someone who built a career by doing his due diligence before making an investment—but then apparently let his guard down when hiring someone he knew. Wyly accuses Glass of overstating his earnings, investment performance, and the size of the assets he managed when he worked for Icahn, and exaggerating his role at another firm where he had worked—all things that could have been checked out more thoroughly before he hired Glass. The upshot, Wyly's complaint concludes,

Wyly knew Glass for 20 years before hiring him as a hedge-fund manager. Suits were filed within months

is that he never should have hired Glass because he wasn't qualified to manage the fund. In his response, Glass denies the charges.

For Wyly to get involved in a tussle that has the hedge-fund world buzzing is certainly out of character for the intensely private 68-year-old Louisiana native. Over the past 40 years, the boyish-looking entrepreneur amassed his fortune with deft bets on everything from oil and silver mining to restaurants and software. Until recently, the avid history buff and staunch supporter of President George W. Bush was little known outside Texas. But then he picked high-profile proxy fights in 2001 and 2002 with Computer Associates International Inc., which in 2000 had bought his software company for some \$4 billion. Last summer, Wyly dropped the campaign—which he said cost him \$14 million—after CA settled with him for \$10 million; later the company implemented several of his suggested reforms.

Wyly then returned to the hedge-fund business. His first foray had been a big success: In 1990, he co-founded Maverick Capital Ltd., which today has some \$8 billion in assets. Since 1993, son Evan, a Maverick co-founder, and former Tiger Management money manager Lee S. Ainslie III have managed the fund. Wyly is still an investor but has no management role.

It was his battles with CA that led Wyly to create the corporate governance fund. "Institutional investors suggested that he turn his experience with CA into a business," Wyly says in his complaint. The fund was to employ a "catalyst" value-investing strategy: taking stakes in companies that are underperforming due to poor governance, initiating a transforming event—such as a proxy fight—with the aim of raising the value of the company and its stock. As Wyly told *BusinessWeek* in March, he had become "a born-again, good-governance guy."

For the person to run Ranger Partners, Wyly turned to Glass, "a family

friend," according to Wyly's suit. Not only had Glass and Evan attended college together but they were also later partners at Premier Partners Investment Research, an investment research boutique. Wyly says Glass ingratiated himself by, among other things, telling him that he carried photos of his grandchildren in his wallet and had photos of his son's wedding on his desk. Glass told *BusinessWeek* in March: "I have had a long-standing relationship with Sam and Evan that goes back to the early '80s."

startup costs. What's more, Glass was to receive an annual salary of at least \$350,000, plus loan commitments to him pay taxes resulting from his interest in the fund.

Now, Wyly feels Glass snookered him. "By materially overstating his track record, Glass made himself appear to be more attractive to potential investors, which in turn induced Wyly to agree to the extremely favorable terms that Glass received," Wyly says in his suit. Glass denies this.

For his part, Glass says his agreement called on him to help develop "a complex of investment funds," but claims he wasn't allowed to. Glass asserts he began developing an alternative fund late last year but then Wyly yanked him away from him. In May, a Wyly-controlled company launched a fund called Ranger Arbitrage. Wyly's suit says Glass came aboard to help with "a single fund" and the idea for an arbitrage fund was not brought to him by Glass.

Wyly's main complaint appears to be that Glass

mismanaged the fund, investing about 18% of its capital. He claims the majority of Glass's bets were "strategic fixed-income investments" that didn't meet the fund's objective. The bets that did were "tiny toehold" positions that didn't benefit the fund. Wyly's suit maintains that Glass's largest single investment was in bonds issued by HealthSouth Corp., which is now the subject of a Securities & Exchange Commission investigation. Wyly's suit says the investment lost \$10.5 million. The fund ultimately raised only \$3 million of the initial \$350 million goal. In his response, Glass denies he mismanaged the fund.

In any case, the fund's limited partners received "nearly 100% of their money back," Wyly exec Canon said in a statement, and have put the episode behind them. But for Wyly and Glass, divorce proceedings are just beginning.

By Stephanie Anderson
in Dallas

MESSY BREAKUP

Sam Wyly and one of his former hedge-fund managers, Russell Glass, are locked in an ugly legal battle.

GLASS SUED FIRST...

- Charging breach of contract and demanding at least \$200 million from Wyly.
- Contending that he was hired to develop a group of funds—not just one fund, as Wyly says.

WYLY COUNTERSUED...

- Charging that Glass mismanaged the fund and misrepresented his investment track record, which Glass denies. He's demanding at least \$16 million in damages.

That's about all Wyly and Glass seem to agree on now. They even dispute who approached whom about working together. Glass contends Wyly "solicited" and lured him away from his four-year post as president and chief investment officer at Icahn Associates Corp. in New York. Wyly contends that Glass "approached" him.

Either way, Glass signed on with Wyly in January, 2002, for a huge compensation package, which is outlined in the suits. For starters, Glass got a 60% stake in Ranger Partners. Then, one of Wyly's investment vehicles, Ranger Entrepreneurs LP, put \$10 million into the new fund on Glass's behalf and, in exchange for a 35% stake in the fund, pumped in \$40 million more. Ranger Entrepreneurs also invested \$3 million on Glass's behalf in "a separate Wyly-controlled investment vehicle" and awarded Glass an interest in the profits. For good measure, Ranger Entrepreneurs kicked in \$3 million for the fund's



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COMMENTARY

By Gary Weiss

COMPETING WATCHDOGS ARE GOOD FOR THE STREET

It smacked of the worst kind of grandstanding. On Aug. 10, in a lawsuit, press release, and press conference, Massachusetts fired the first shots in a legal war against Morgan Stanley. The allegation was that the firm put its revenues far ahead of the interests of its customers. Secretary of the Commonwealth William F. Galvin accused the firm of "fraudulent" practices that gave brokers special incentives, including sales contests, to sell its in-house funds. Morgan Stanley declined comment pending its formal response to the suit.

The timing of this action was either propitious or suspicious, depending upon your point of view. It coincided with an effort in Congress by House capital markets subcommittee Chairman Richard H. Baker (R-La.) to curb state securities regulators' powers (BW—July 28). The practices complained of in the suit are not explicitly prohibited and are widespread. The Massachusetts action thus would appear to be more hype than substance, if not for one thing: This is just the kind of intense policing that Wall Street desperately needs.

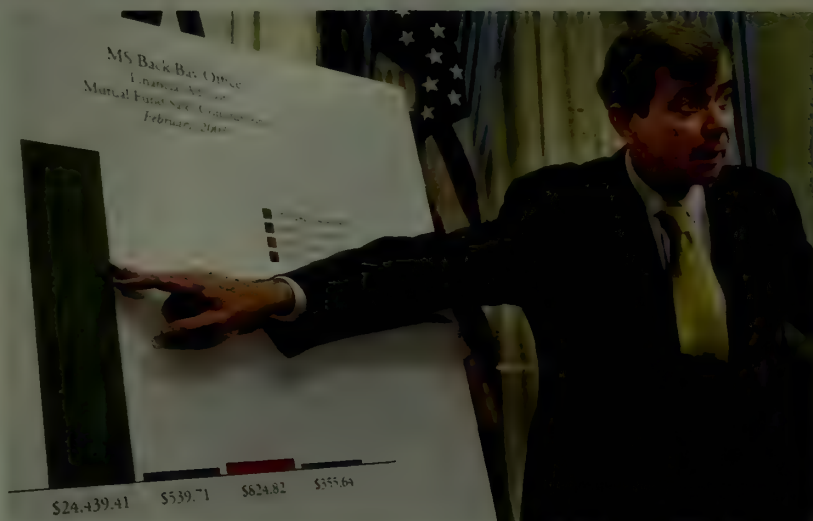
Motives notwithstanding, Massachusetts' assault on Morgan Stanley points up the need for vigorous state regulators to pursue their own investigations and enforcement actions against securities firms. The practices described in the Morgan Stanley suit have been allowed to flourish on the Street by the Securities & Exchange Commission and NASD—which only just proposed a rule dealing with the issue—in the same way as analyst conflicts went unchecked until New York State Attorney General Eliot Spitzer stepped up to the plate. Says Henry T.C. Hu, a corporate and securities law professor at the University of Texas: "In a perfect world, there would be no role for state regulators for this kind of stuff. But in the real world, regulator

ry competition is very useful—it gets the blood going."

The SEC certainly could use a nudge. Chairman William H. Donaldson has commendably moved to beef up mutual-fund fee disclosures but has yet to show much stomach for going after sales practices at the big firms. It's high time he did. Way back in '95, an SEC blue-ribbon committee found persistent conflicts of interest in the way investment firms paid brokers—including some of the same practices that Galvin alleges Morgan Stanley followed. Such things "have been going on in the brokerage business forever," says Bryan Farrell, a former federal prosecutor who is now managing director of Smith &

Carson, a private investigative outfit. Such "going on forever" stuff bores the feds, but not the states. Historically they have been swifter to act against deeply ingrained, questionable industry practices than the SEC and NASD. Long before Spitzer moved against analysts—thereby prodding a somnolent SEC into action—state regulators were among the first to hone in on microcap fraud, beginning with a multistate initiative in mid-1996. That sparked competition among the states, the SEC, and the NASD to prosecute microcap crooks—a flurry of activity that led to dozens of civil actions and criminal prosecutions. Ultimately, the outcome was beneficial to investors, because cases not pursued by the feds were often picked up by local prosecutors such as Manhattan District Attorney Robert Morgenthau.

Investors will probably benefit, too, from a similar competition to act against large-firm mutual-fund sales practices. The exhibits in the Massachusetts case against Morgan Stanley, posted on Galvin's Web site, paint a sorry picture of a firm that apparently gave brokers huge incentives to push Morgan funds. Critics of state regulators maintain that the U.S. securities market should have only one watchdog: the SEC. Baker's legislation would prevent the states from imposing tougher rules on brokerages than the SEC's. This idea, endorsed by Donaldson and Federal Reserve Chairman Alan Greenspan, has an appealing orderliness. But before endorsing it, Congress needs to consider whether it wants a neat-as-a-pin securities-oversight scheme that protects SEC and NASD turf—or a feisty, competitive one that protects investor interests.



MASSACHUSETTS' GALVIN: Filing suit against Morgan Stanley

Mixed Performers

Funds run by brokerage firms often lag behind their peers

COMPANY	TOTAL RETURN*
SALOMON BROS. ASSET MGMT.	16.73%
SMITH BARNEY FUND MGMT.	16.13
BEAR STEARNS ASSET MGMT.	16.09
AVG. OF ALL US EQUITY FUNDS	15.98
MORGAN STANLEY INV. ADV.	15.86
AM. EXPRESS FINANCIAL	15.23
MERRILL LYNCH INV. MGMT.	14.72
CREDIT SUISSE ASSET MGMT.	14.17
J.P. MORGAN ASSET MGMT.	14.02
GOLDMAN SACHS	12.94

*Year to date as of Aug. 14, and not adjusted for sales charges

Data: Lipper

Senior Writer Weiss covers corporate crime.



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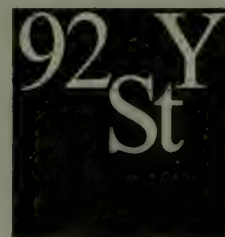
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SEPTEMBER 1, 2003

MAKING LIFE RICHER

Saving for College

Are 529 Plans Still
the Best Bet?

Page 92

STOCKS 94
Market Update

TECH 97

Audio A8

MARKER 100

Wolf Deal





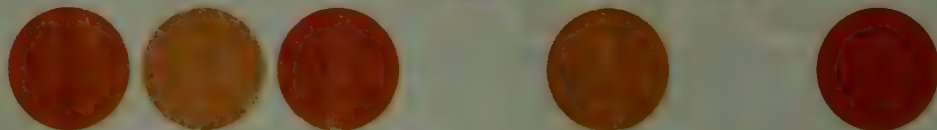
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that 57% of Americans
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Computer Folk...

computers at least	90%
increase computer	62
next year	
at all photos	56
be digital	
download	27

Data: InsightExpress



**\$1 MILLION
TROPHY
HOUSES
ABOUND**

RETIREMENT

Palaces for the Golden Years

A FLORIDA CONDO and early bird dinners? Forget about it: An increasing number of Americans among the 5.5 million expected to retire this decade will opt for \$1 million-plus trophy homes with spas, exercise rooms, and home theaters. "The people buying these homes have worked hard their whole lives, and now they've earned a retirement that is going to be all about them," says consultant John Burns, who studies the retirement-home market. Burns figures 3.5% of coming retirees are the target market for these luxury dwellings—based on 2000 U.S. Census data that show 3.5% of households in the age 55 to 64 category earned more than \$200,000 annually.

Jeffrey Prostor, a luxury home builder in Southern California, says popular features in the 55-plus age group are low-maintenance yards just big enough for a lap pool and ground-floor master bedroom suites suitable for wheelchair use. Many retirees who can splurge on senior-style McMansions are awash in cash from selling a house in today's heated market they bought years ago. Also, "we're finding people over 55 are willing to take on more debt than previous generations," Burns notes. They would rather live in a million-dollar house with a \$500,000 mortgage than a more modest home they buy outright.

BARBECUING

SET TO SIZZLE

Just in time for Labor Day, here are two hot new barbecue items. Planning a cookout in the park? Rather than

lug charcoal, take along the 41-pound Weber Q portable gas grill (\$179). The cast-iron grate can hold 18 burgers, and one-touch ignition makes lighting the fire a cinch.

WEBER Q



With the \$75 stainless steel Grill Alert probe from Brookstone, just enter the type of meat you have and how you want it cooked, then clip a wireless receiver to your belt. The screen

GRILL ALERT



displays existing and target temperatures, and soon a digitized voice will say: "Your entrée is ready."

Time to Rethink The 529

Sweeping changes in tax laws may make other college plans more advantageous.

BY ANNE TERGESEN

The tax-free status of state-sponsored college savings plans—known as 529 plans, after the part of the tax code that created them—once made them the best deal around. But because of recent tax cuts, other approaches are now almost as attractive from a tax angle. Moreover, since many 529 plans charge high fees, it's possible to come out ahead with a taxable investment—as long as it has rock-bottom costs. The lesson: A 529 is

not the no-brainer it was just a few months ago.

The 529's tax advantages can still make it a winning strategy. You'll pay no taxes on your investment gains unless you tap the account for something aside from higher education. Better still, half the states allow investors to deduct at least a portion of their 529 contributions from state income taxes.

If your home state's 529 plan offers a generous deduction, think twice before pursuing a different option. Consider the Missouri Saving for Tuition Program. It gives couples a state-tax deduction for up to \$16,000 in annual contributions. For a family in the state's

top tax bracket of 6%, that works out to a savings of \$120 a year on a \$2,000 annual investment, says Jennifer Ma, a research fellow at the TIAA-CREF Institute, the research arm of TIAA-CREF. CREF runs 529 programs for 13 states, including Missouri (although come November, it will no longer run New York's plan). That's more than enough to offset the slightly higher fees you'll pay in Missouri's plan, which charges 0.65%—or \$13 a year for a \$2,000 investment—vs. \$3.60 for the same contribution to a low-cost index fund that charges just 0.18%.

In the absence of a tax deduction, however, the 529's fees can erode the tax advantage. That's because 529 plans levy several layers of fees. They include expense ratios on the plan's mutual funds, as well as program management fees to cover administrative costs. In addition, some charge enrollment and account-termination fees. And if you sign up through a broker—as a growing number of people do—you could pay a sales



much as 5.75% of your contribution, says Joseph Hurley, founder of gforcollege.com, which compares plans.

To see how this can add up, look at the College Achievement Plan. It costs between 0.67% and 1.77% a year for the individual funds it offers, plus a program management fee of 0.5%. Out-of-state residents with balances below \$25,000 pay a \$25 annual maintenance fee. As a result, investors fork over more than \$1,000 a year for their account's assets each year over these costs. That's a serious cost in an era of low investment returns.

THE FEES

Your state's plan offers no deduction for its fees, you may do better with another type of tax-advantaged investment account—a Coverdell Education Savings Account. It works like a 529 in that you can withdraw money for college tax-free. The trick with a Coverdell is to qualify: Only single taxpayers earning less than \$95,000 and married couples making less than \$100,000 are eligible to fully fund them. There's a cap of \$2,000 on annual contributions.

Even there's the long-standing custodial account. With these, only the first \$1,000 of earnings is tax-free. But if your child is 14 or older, the tax hit from a custodial account is likely to be small. Because taxes on investment income of more than \$750 are computed at your child's rates. If you can invest money in a way that it earns only capital gains and long-term capital gains, you pay Uncle Sam just 5%—assuming your child's taxable income is below the \$28,400 threshold for the bottom tax brackets. Under the old tax law, you would have paid as much as 15%. One caveat: If your child is under 14, earnings beyond \$1,500 a year are taxed at your rate.)

Fees on a Coverdell or custodial account can be quite low. That's because the only fees you should pay are the expense ratios on your funds. Put the Standard 500 Index fund into your Coverdell or custodial account, for example, and you'll pay an annual expense of just 0.18%. In contrast, a stock fund costs about 0.80% in California's plan.

Fees can make a big difference when it comes to returns. Consider an investor in the 28% tax bracket who contributes \$2,000 a year to an equity fund in a 529 plan that costs 1% a year and

How The Plans Stack Up			
PLAN	TAX STATUS	ADVANTAGES	DISADVANTAGES
529 Plan	Tax-free*	Some states offer extra tax breaks.	Fees can be high.
Coverdell Account	Tax-free*	Huge number of investment choices.	Contributions capped at \$2,000/year.
Custodial Account	First \$750 in investment income each year is tax-free. Next \$750 taxed at child's rate.	Huge number of investment choices. Children 14 and older pay tax at their own rate on gains above \$1,500.	Investment income above \$1,500 a year is taxed at parent's top rate if child is younger than 14.

*If used for higher education expenses

offers no state tax deduction. If the fund earns 6% a year, the investor will have nearly \$59,000 available for college 18 years later, according to TIAA-CREF. But the investor could have about \$4,500 more with a custodial account, and about \$5,400 more with a Coverdell account. The reason? The 529 costs 1% a year. But with a Coverdell and custodial account, you'll pay just 0.18% if you invest in a low-cost Standard & Poor's 500-stock index fund.

The 529 approach can also lag behind when it comes to age-based portfolios. These investment programs automatically shift from stocks to bonds as a child approaches college age. In the case of a \$2,000 annual contribution that earns 6% on its stock and bond investments and 4% on its money-market funds each year, the 529 plan accrues nearly \$58,000 after 18 years, compared with just over \$63,000 for a Coverdell

and \$61,400 for a custodial account.

Again, higher fees set the 529 back. Instead of paying 1% for an age-based portfolio in the 529, an investor can replicate these same allocations in a custodial or Coverdell account for as little as 0.18% for a stock fund, 0.22% for a bond fund, and 0.33% for a money market fund. (If your college savings strategy is heavily weighted towards bonds from the outset, it makes sense to shield the taxable income they generate in a 529 or Coverdell, instead of a custodial account.)

WHO HOLDS THE PURSE STRINGS?

There are trade-offs to investing in these other accounts. With a custodial account, the money becomes your child's to control at 18 or 21: The exact age depends on your state's laws. As a result, you have to be confident your child won't skip college and blow the money on other things. Also, keep in mind that the more you plan to contribute each year, the greater your custodial account's potential gains—and tax bill.

Finally, although it's hard to predict future financial needs, those who anticipate applying for financial aid may be better off with a low-cost 529 plan. That's because the federal government's financial-aid formula considers only up to 5.6% of the balance on a 529 owned by a parent available to pay for college. In contrast, 35% of the dollars in custodial and Coverdell accounts are counted towards the family's college contribution.

To complicate matters further, today's tax rates may not remain in effect for the long term. The tax-rate reductions that have given custodial accounts a new lease on life are due to expire on Jan. 1, 2009. Meanwhile, 529s are scheduled to lose their tax-exempt status in 2011. Congress may act to block the tax hikes. But regardless of what happens to the tax code, the lesson is clear: It's not only tax advantages that matter; fees do, too.

Low-Fee Programs

You don't have to live in a particular state to enroll in its 529 college savings plans. If you're shopping across state lines, here are some plans with low fees.

STATE PROGRAM	FEE*
California's Golden State ScholarShare College Savings Trust	0.70% to 0.80%
Iowa's College Savings Iowa	0.65%
Missouri Saving for Tuition (MO\$T) Program	0.65%
Nevada's Vanguard 529 College Savings Plan	0.65% to 0.85%
Utah Educational Savings Plan (UESP) Trust	0.25% + \$25* to 0.9% + \$25**
Virginia Education Savings Trust	0.85% to 1.00%

*Program management fee plus expense ratios on funds

**For account balances over \$5,000

Data: Savingforcollege.com

A Net to Get Caught Up In

Our index shows all the good stocks aren't taken yet.

BY TIMOTHY J. MULLANEY

A year ago, Internet stocks were the dateless, unwanted dweebs of the high school prom. But like a good Mom, *BusinessWeek* said their day would come. Last August, we rolled out the Real-World Internet Index and told investors these Web companies were worth a shot. Our mailbag said we were crazy. But on the RWII's one-year anniversary, we have a verdict: The index is up a sizzling 71.1% through Aug. 15, mocking the 6.6% gain in the Standard & Poor's 500-stock index.

Now investors have a *Sex and the City*-worthy lament about Net stocks: Are all the good ones taken? After all, 7 of the 20 original RWII companies have been acquired. Barry Diller's InterActive, bought four: Expedia, LendingTree, Ticketmaster, and Hotels.com. Among those remaining independent, valuations are high, especially for high-profile names like eBay and Amazon.com. Five have risen 125%-plus since last August, with low-cost Web access provider United Online's 208% gain leading the way.

The good news: There are more worthy Net stocks where those came from. None is quite the company that, say, recently acquired Web travel agency Expedia is. And collectively, common sense says you can't expect the RWII to rise another 71% by next August. But the new stocks we're adding are bets on long-term trends that drive growth and trade at reasonable multiples of earnings. Yes, earnings. You don't get into this Net index without them.

HERE ARE THE NEW ADDITIONS:

Priceline.com replaces Hotels.com in the index. Still the leader in deep-discount travel, Priceline has cut costs and is set to make consistent profits. Travel booking is moving online fast, and Price-



line is both exploiting its name-your-own-price model and selling cheap travel using conventional pricing. The stock is pricey at 78 times this year's profits, but restructuring will let profits rise much faster than sales. Priceline is also a good buyout candidate.

Ameritrade, the online stockbroker, takes the place of Web-savvy mortgage lender IndyMac Bancorp for a simple reason: The stock market is picking up while the mortgage market cools. Earnings per share for the first nine months

of its fiscal year, through June, 138%. Revenues rose 64%, thanks largely to customers Ameritrade gained through last year's merger with Datek, while costs rose only 33%, thanks to merger-related efficiencies.

Symantec substitutes for Netscape Associates. Both are direct competitors in the virus-protection business, but Symantec has had trouble earning, leading to a 95% drop in second-quarter profits and making Symantec a better pick.

FindWhat.com replaces Overture Services, its former rival in the pay-per-click advertising business. Like Overture, FindWhat sells ads tied to search results. Advertiser-friendly model because it only charged if surfers clicked on the ad to visit their site. FindWhat is a buyout candidate, but as an independent, its price-earnings ratio of 44 on last year's earnings is better by Net standards—compared to projected 71% annual profit growth over five years. Overture is

acquired by Yahoo!.

Subbing for LendingTree is **Discover**, a software company with products power banks' Web banking services. With a price-earnings ratio of 37 on this year's earnings and projected five-year profit growth of 30%, it grows with the online-banking market.

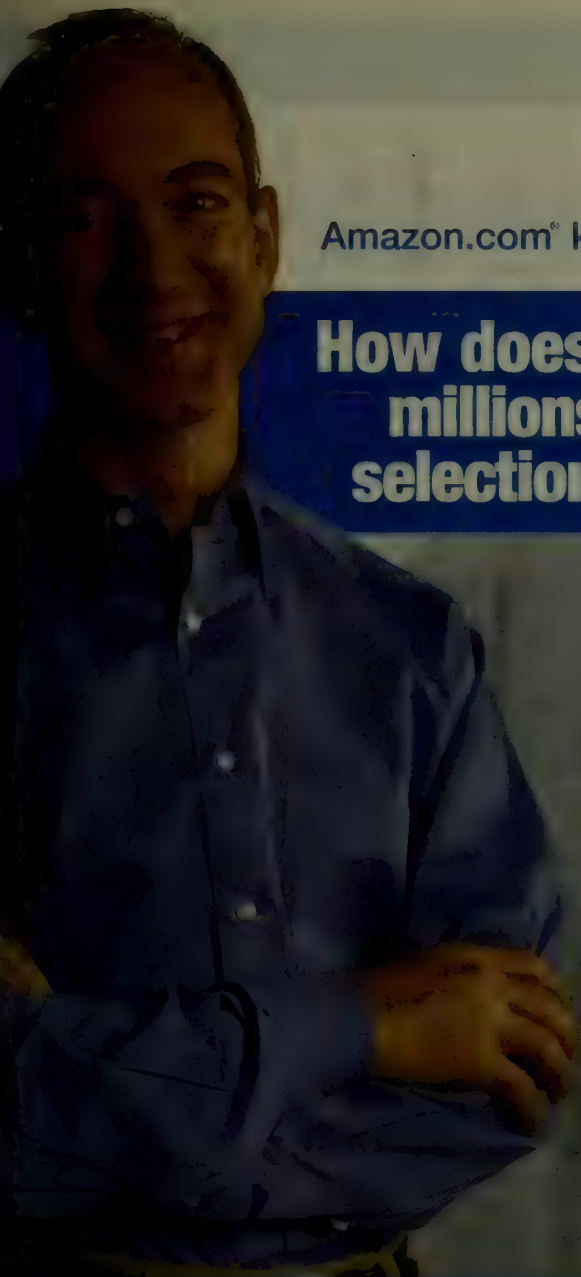
Monster Worldwide moves into the slot occupied by e-tailer Alloy O. The worst performer in the index with a 20% loss. Analysts say earnings will grow nearly 50% next year on a 9% sales gain, which makes sense

Best of the Net Stocks

NAME/SYMBOL	PRICE	52-WEEK GAIN	PRICE-EARNINGS RATIO
Digital River DRIV	\$21.43	202%	36
Profits for online software-distribution manager projected to grow 25% a year through 2007.			
eBay EBAY	102.35	76	58
Pricey, but among the best-run companies in techdom—or anywhere else.			
InterActive IACI	35.78	56	47
Stock will get boost as Barry Diller simplifies company finances and Web travel site Expedia powers profit growth.			
United Online UNTD	33.80	192	34
Low-price leader in Web access is taking share fast from America Online. The p-e is roughly the same as its earnings growth rate.			

* Based on estimated 2003 earnings, except for United Online, which is based on the fiscal year ending June 30, 2004.

DAVID MURPHY/ISTOCK



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tech-driven employment-advertising service in a recovering economy. Our worry is its p-e ratio of 65 on 2003 earnings. Finally, we add E*Trade Group to replace Intuit. Intuit sold its online mortgage business to focus on software.

The RWII was set up to be a conservative way to play the Net. In this year's market, you actually made bigger gains on stocks that had fallen hard since 2000, like Priceline, Find-What, online entertainment player RealNetworks, or Web-infrastructure company VeriSign. We rejected them all last year in favor of safer names like IndyMac and cash-rich Register.com; VeriSign and RealNetworks are still too fundamentally shaky for this index. Our goal was to identify those Net stocks that were about to post hefty earnings gains without betting wildly on companies that are still struggling to turn a profit. That's what the index did—and ought to do again. ■

BW's Real-World Internet Index

Company	Symbol
1-800 Flowers.com	FLWS
Amazon.com	AMZN
Ameritrade Holding	AMTD
Digital Insight	DGIN
Digital River	DRIV
eBay	EBAY
eSpeed	ESPD
E*Trade Group	ET
FindWhat.com	FWHT
InterActiveCorp	IACI
Monster Worldwide	MNST
Netflix	NFLX
Priceline.com	PCLN
Register.com	RCOM
Symantec	SYMC
United Online	UNTD
University of Phoenix Online	UOPX
WebEx Communications	WEBX
Yahoo!	YHOO

Data: BusinessWeek

Taking Book Value Off the Shelf

The measure, lately out of fashion, is a deft way to gauge earnings quality. **BY ROBERT J. ROSENBERG**

Just about every valuation measure went out the window in the go-go '90s. Few, though, landed with a greater thud than book value. Once a favorite tool of Benjamin Graham, the investment guru who wrote the book on security analysis, it became unfashionable as a measure of a company's intrinsic worth. After all, book value was better suited to accounting for smokestacks and steel slabs than the more ethereal assets of the New Economy.

But now book value is getting a fresh look, not as a valuation tool but as a means of gauging earnings quality. Simply put, comparing the growth in book value to the growth in earnings "is a nice reality check," says Richard Maroney, director of research for *Dow Theory Forecasts*, an independent investment newsletter.

In theory, at least, book value is what would be left over if the company were to go out of business that minute. The number-crunchers calculate book value by beginning with total assets, then subtracting long-term debt and other liabilities and preferred stock. Some analysts also take out intangible assets such as goodwill, trademarks, and patents to calculate the "tangible book value," but that's not necessary for this sort of analysis. Once you figure the book value, in millions or billions, you divide it by the number of shares outstanding to arrive at book value per share, which is easy to compare against earnings-per-share reports.

Sure, the decade of mergers and acquisitions, corporate restructurings, and share repurchases has made book value a sometimes squishy number. Book val-



ue can increase as a result of mergers and it can go up if a company has sold a lot of new equity. But the regular contributor to the growth in book value is retained earnings, or earnings after dividends. That's why monitoring the changes in book value is worthwhile.

How does it work? Maroney compares a company's compounded annualized growth rate of operating earnings over three years and checks on whether book value is going along the same trajectory. In the past three years ending August, for example, Walgreen's operating earnings have grown 16.5% on average; book value has kept pace, increasing at a 21.4% rate during that period. In the current fiscal year, operating earnings have risen 13.3% in the three quarters, while book value has risen 11.8%, suggesting solid earnings.

The method sometimes sends a red flag on companies that may be reporting strong earnings, but when

lying trend in book value
es the opposite. A classic
is BellSouth, says
ey. From 1990 to 1996,
uth's earnings went from
\$1.27, a 6.9%-a-year av-
annual increase. But dur-
at period, "book value
from \$6.63 to \$6.68, basi-
showing no change,"
ey says. Or take a look
oZone, an auto-parts re-

Over the three fiscal
ending in August, 2002, earnings
n average of 34.9% a year, while
value per share fell 9.9%.
t look for absolutes. Book value

WHEN GROWTH IS IN SYNC

COMPANY / SYMBOL	OPERATING EARNINGS GROWTH RATE*	BOOK VALUE GROWTH RATE*
Walgreen WAG	16.5%	21.4%
General Dynamics GD	13.5	17.9
Home Depot HD	16.0	17.1
Johnson Controls JCI	15.4	15.5
Wal-Mart Stores WMT	13.1	15.0

*Annualized compounded growth rate, based on last three fiscal years

Data: Compustat, Bloomberg Financial Markets

growth doesn't need to match earnings
growth, but it ought to be close. Also,
it's a matter of degree: A company with
25% earnings growth and 22% book val-

At a minimum, says Ketz, they "bring
some credibility to the [earnings] num-
bers." In these nervous times, that's no
small measure. ■

ue growth is in a better posi-
tion than one whose earnings
are expanding by 6% and
whose book value is up only
3%. This reality check doesn't
help when numbers are fraud-
ulent, as with Enron or
WorldCom.

For all their shortcomings,
says J. Edward Ketz, associ-
ate professor of accounting at
Pennsylvania State University,
book values are worth a look.

Discreet Luxury

Audi A8 won't turn heads, but it's
class act. **BY CHRISTINE TIERNEY**

D exacting German critics awarded high
marks to Audi's all-new A8 flagship
when it was introduced in Europe
last fall. Sure, some carped that the
car looked too much like its conserv-
atively styled predecessor. But as I
discovered when the \$69,190 car hit
the U.S. this summer as a 2004 model,
the most conspicuous changes are

the inside.

biggest innovation? A high-tech Multi Media Interface
system that controls more than 200 functions, from
station programming to road navigation. It's Audi's an-
to a dilemma that faces luxury auto makers every-
They need to distinguish their flagships from main-
n models already well equipped with just about
thing a driver needs. So they pile on more technology.
at's a tough sell, given that their customers are fifty-
ings who didn't grow up with video games and laptops.
as up to the challenge, though. Audi's MMI has a 7-in.
that flips up when you press a small panel on the
You move a cursor around the screen by

g a knob set between the
directly behind the gear
and enter commands by
g down on the knob. For
st often used features, such
radio, phone, and CD player,
n jump directly to the con-



FLIP-UP SCREEN:

A cursor
controls 200
functions

I were a woman, I'd call a taxi," my landlord joked. Still,
without cracking any of the owner's manuals, I found all the
functions I needed within a half hour.

Once on the road, I made up the time. (Reminder: Set the
speed-warning system to alert you when you exceed set
speed limits.) The A8 handles beautifully. It has all-wheel
drive, a six-speed transmission, adjustable air suspension, and
a quiet V-8 engine delivering 330 horsepower. It handles so
nimble and precisely that, at 80, this car feels like it's doing
50. Yet for all the oomph, fuel economy is reasonable. Built
on an aluminum frame, the A8 gets 17 mpg in the city and
24 on the highway.

When it comes to styling, the car is handsome and well-pro-
portioned, but not ostentatious. It'll never elicit the love-or-hate
reactions to rival BMW's 7 Series and its controversial rear end.
Instead, it's like a fur-lined trench coat: Simple and classic, but
with comfort and luxury
awaiting inside. ■

POWER AND PRECISION:

330 horses,
nimble
handling, 24
mpg/highway



My First Handheld

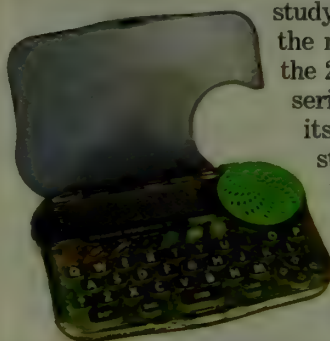
Want to give your kids an electronic advantage? **BY SUSAN SCHERREIK**

Kids are no different from Mom and Dad when it comes to scheduling. They need to juggle school assignments, play dates, and soccer practice. One thing that might help: a personal digital assistant (PDA) designed for the younger set. It's one of several back-to-school gadgets that we tested. Here's what we found.

iQuest (\$59.99; leapfrog.com) is a terrific organizer with its easy-to-use date and address books. But its most impressive feature is a customized homework helper tied to over 250 math, social studies, and science textbooks for fifth to eighth graders. For that, you need to purchase a cartridge for each subject and grade (\$14.99 each). You have a fifth-grader studying math? Your child can click on the name of his textbook from among the 25 listed, and iQuest will provide a series of multiple-choice questions on its easy-to-read screen. When stumped, kids can ask for hints to the correct answer or explanations when they are wrong.

Leapfrog's \$49.99 Quantum Pad enlivens rote learning with games and other activities, aimed

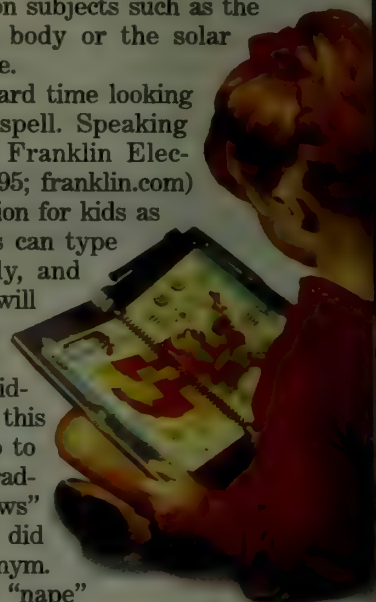
FRANKLIN'S SPEAKING HOMEWORK WIZ



IQEST GOES BEYOND SCHEDULING

system for \$14.99 apiece.

Kids often have a hard time looking up words they can't spell. Speaking Homework Wiz from Franklin Electronic Publishers (\$49.95; franklin.com) tries to provide a solution for kids as young as six. Students can type in a word phonetically, and this colorful handheld will display the proper spelling, speak the word, and provide a kid-friendly definition. But this feature isn't always up to snuff. When my first-grader Clare typed in "rows" for "rose," the device did not recognize the homonym. Nor did it guess that "nape" was supposed to be "nap." A third grader with a better grasp of spelling is likely to have more luck. Like many Franklin gadgets, this one comes with a "better grades or your money back" guarantee. But if it can't do a better job of figuring out what young kids are asking, parents may ask Franklin to make good on its promise.



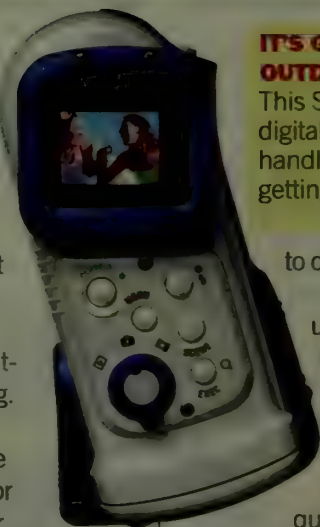
QUANTUM PAD TEACHES W GAMES

CAMERAS

Get the Picture—With One Hand

Finally, a digital camera tailored just for the surf-and-ski set. Sony has taken its popular Cyber-shot U camera, turned it vertically, and wrapped it in a rugged, waterproof housing. The result is a \$249 camera that's easy to use with one hand (if you're right-handed) while you're swimming, surfing, or snorkeling. Advice to southpaws: Adapt. It's worth it.

In your hand, the 2-megapixel DSC-U60 feels more like a cell phone than a camera. For setting up shots or replaying them, you can work all the buttons with your thumb. When you're ready to shoot, the shutter is an easy reach for your index finger.



IT'S GREAT OUTDOORS:

This Sony digital can handle getting wet

And here's a clever twist: The entire camera body is canted some 30 degrees from the vertical to compensate for the natural curve in your arm as you hold the camera in front of you. When you rest it on its base to use the self-timer so you can get into the picture, the camera

to offset the unusual angle.

So what's not to like? The U60 isn't good for serious underwater photography: Sony says you can only go 5 feet down (although it has been tested to 15 feet). There's no viewfinder, either, so you must compose your shots on the LCD display which, at 1 inch, is on the small side.

But hey, we're not talking about producing gallery-quality fish portraits. We're talking about having fun with a camera that's snow- and sand- and beer-resistant.

Larry Arms



Hunting Buried Treasure By GPS

port of geocaching runs on
lite signals. **BY KATE MURPHY**

IKE CHRISTOPHER Columbus and Meriwether Lewis, Brian Sniatkowsky is an intrepid explorer. Only instead of discovering new territory, Sniatkowsky finds Tupperware con-

ceivers or GPSr is a popular new pastime. All you need is a little technical knowhow and a sense of adventure.

This is an activity where the spoils are secondary to the thrill of discovery. The sport dates from May, 2000, when President Bill Clinton signed an executive order making GPS signals available for civilian use. The ability to receive GPS signals emitted from orbiting military satellites allows you to pinpoint where you are anywhere on earth.

To find a cache or stash, you need to buy a GPSr for \$100 to \$800. Although you might like the mapping and memory features of the high-end models, they won't make you any more successful at locating a stash. Make sure that whatever GPSr you choose has a battery life of at least 20 hours and a wristband or lanyard, so you won't drop it in high grass or water. Enthusiasts, known as cachers, recommend the Magellan and Garmin brands for their sturdiness and dependability.

Next, you need cache clues. A handful of Web sites list the latitude and longitude coordinates of stashes. The most popular is www.geocache.com, but you can also go to navicache.com and brillig.com/geocaching/. Just enter the state, city, or Zip Code where you want to find a cache. Caches are hid-



IT'S IN THE TUPPERWARE: Sniatkowsky may find action figures or Silly Putty in one of 50,000 stashes of prizes

den in urban as well as wilderness areas. Some may even be underwater and require scuba gear to retrieve. The level of difficulty is rated on a scale of 1 to 5. A

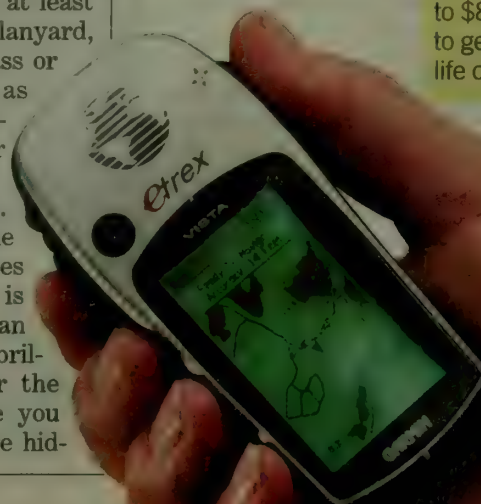
cache in the Saudi desert is a 5.

Once you input the coordinates, your GPSr will tell you how far the cache is and point you in the right direction. Your receiver will guide you to within 20 feet of the stash. "Then, intuition takes over," says Jenn Seva-Kutch, a project manager at the Edward Lowe Foundation in Reading, Pa., which helps entrepreneurs. She began geocaching after she won a GPSr in a December, 2001 raffle. Caches are often hidden under bushes or in tree stumps.

Once you find a cache, you can take out one item, provided you add something else. Typical contributions include toys, software, books, and trading cards. Nothing should be edible, as critters will get to it first. There will also be a logbook to sign. When you return home, you'll need to go back to the Web site where the stash's coordinates are posted and tell others that you found it.

Geocaching can be a leisurely individual pursuit or a competition to see who can find the most stashes in the shortest time. Either way, cachers say, treasure hunting with a GPSr is more chic than with a metal detector.

A HANDHELD GPS RECEIVER: Models run \$100 to \$800. Be sure to get a battery life of 20 hours





WHY IS CALLAWAY CHASING GOLF BALLS?

BY ROBERT BARKER rb@businessweek.com

ABOUT PLAYING GOLF, what I know fits neatly on a tee's pointy tip (that end goes up, right?) Yet I can't help thinking the people at Callaway Golf also have some things to learn, in their case about investments, deep losses, and when the time comes to cut them. To see what I mean, keep your eye on the Callaway golf ball.

Since its start in 1982, Callaway has built its brand on clubs, a segment it now leads in each key category—woods, irons, and putters—with pretax profit last year of \$179 million on \$726 million in sales. Club sales through June this year rose nearly 5%, and pretax profit 11%. That's impressive, given the dreary economy and a 3.5% drop in the number of golf rounds played in the U.S., according to market researcher Golf Datatech. In part, you probably can credit endorsements from such pros as Annika Sorenstam, who in May drew acres of free publicity as the first woman to compete in a Professional Golfers' Assn. tournament in 58 years. In August, Callaway built its roster further by luring last year's U.S. Amateur champ, Ricky Barnes.

Golf balls have proved a lot tougher for the Carlsbad (Calif.) company. Callaway started selling balls in 2000, but it hasn't broken from a large pack. Sales last year reached just \$66 million, and the first half of 2003 saw ball sales plunge 37%, to \$29.3 million. Callaway's pretax loss on balls topped \$10 million, up from \$6.2 million in 2002's first half.

Soon, at least the sales figures may change. Callaway hopes to buy the No. 2 ballmaker, Top-Flite Golf. Last year, it sold \$186 million worth of balls, plus another \$40 million in clubs. But under the weight of debt taken on in a 1996 leveraged buyout, Top-Flite entered bankruptcy in June. Callaway thought it had a prepackaged deal to snap Top-Flite out of bankruptcy with a \$125 million offer. Then, in July, other bidders, notably adidas-Salomon, maker of Maxfli balls and TaylorMade clubs, swooped in. So the court scheduled a Sept. 3 auction, setting Callaway's \$125 million offer as the bid to beat.

Although Callaway shares have rallied on prospects of a deal (chart), it's no gimme that a deeper investment in golf balls would be bullish.

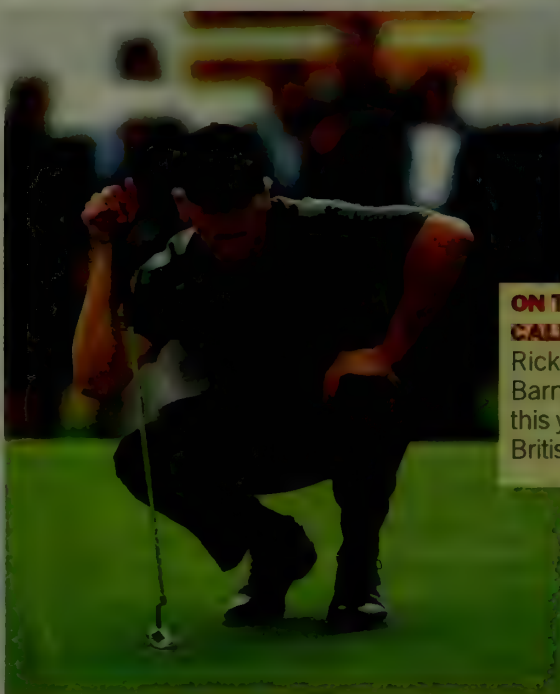
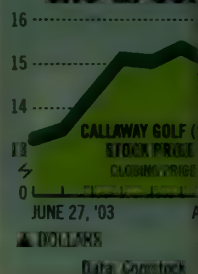
While the company maintains buying Top-Flite is a far better option, it will consider other steps to end its losses on golf balls if it doesn't win Top-Flite. Nor does it make any bones about the blunders it made in balls after spending more than three years and \$170 million in startup costs. For example, it infamously tried to rewrite the ball market's packaging customs, selling boxes of 10 in two five-ball sleeves instead of the common dozen in four three-ball sleeves. Callaway had to retreat and, a spokesman, has "been playing catch-up ever since." Way ahead of Fortune Brands' Acushnet unit, whose Titleist and P balls enjoy more than half of the market.

Worse, all the competition—which also includes Nike put golf ball prices under pressure. Through this year's first half, the average price for a dozen balls fell 4.1%, to \$12.50, according to Golf Datatech, as unit sales sank 5.4%. The trend at Callaway is worse: Although the company aims to sell more balls at the market's premium end, a year ago it had lost its list prices.

All told, 3½ years of selling golf balls has brought Callaway \$184 million in revenue and losses of \$99.5 million. The name doesn't have to be Tiger to know that's one so far from the turn on an initial investment of \$170 million, plus \$51 million in 2002 to buy the manufacturing equipment Callaway had been using.

Now, Callaway proposes to spend \$125 million more on Top-Flite. The deal promises economies of scale, certainly. Callaway figures the ball segment would at last be profitable some time next year, but only after up to \$70 million in write-offs that Callaway estimates would be required in consolidating the companies' operations. In other words, Callaway would spend \$125 million in Top-Flite assets and combine them with its own golf ball assets, which it listed at year-end 2002 at \$100 million. After sorting through \$228 million in merged assets, 100 million of them would evaporate. Someone help me, please: golfers supposed to replace balls, not make the holes deeper?

Approaching the Green



ON TEAM CALLAWAY: Ricky Barnes at this year's British Open

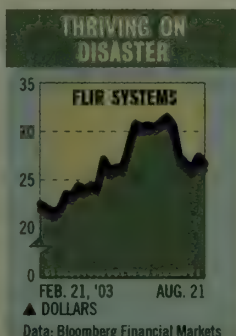


DAVID HENRY

Not So Dark at FLIR

Finding a good growth stock at a reasonable price can be as hard as spotting a terrorist in the dark. FLIR Systems (FLIR) can help on both counts, says Preston Athey of T. Rowe Price, who owns the stock. FLIR makes cameras that work in the

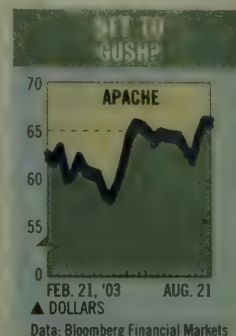
haze, and even in rooms choked with smoke. These are more than night-vision goggles. They read infrared radiation and are not affected by ambient light. Sales to the government, primarily for the military, account for 25% of revenues. Popular TV news helicopters carry the cameras to track felons. Factories buy FLIR versions to detect temperature variations that foretell breakdowns. FLIR sold more than 100 devices to U.S. authorities at \$15,000 apiece to track travelers with high fever that could be SARS. Sales will reach \$305 million this year and grow 16%, to \$355 million, in 2004, estimates Steven Colburn of JMP Securities. FLIR aims to drive down production costs to lower prices enough to spark demand. With a market cap of \$900 million, FLIR sold 3% convertible debt in 2001 to raise \$150 million. Some of the money, the company says, will probably go toward cutting costs through buying component suppliers. The stock trades at 26.50, or 22 times projected earnings per share in 2003. Athey says FLIR is attractive in light of the company's 20% earnings growth. He has owned the stock for several years and rode the accounting blow-up under old management in 2000, when the stock plunged 80%, to \$1.53. Now, Athey is holding it. "It is good for a run into the mid-30s," he says.



Ally Pumping Apache

For a play on accelerating world economies, look to commodities such as oil, say savvy money managers. For an extra kick, buy shares of a company with exceptional skill in helping meet rising demand. Apache (APA), an exploration and production outfit, is a top choice, says Joseph Zock, president of Steinberg Global Asset Management Associates. At 66, the shares are up year-to-date and make the company worth \$11 billion. Zock expects the price to hit 80 in 12 months. (The stock was

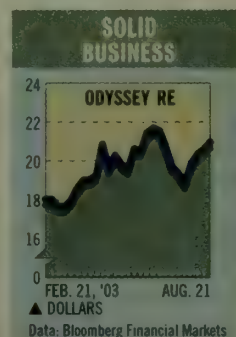
featured in the Apr. 30, 2001, issue of this column at a split-adjusted 54.) Today, the price-earnings ratio is still just 12, based on 2004 earnings estimates of \$5.41 a share, according to Thomson First Call. *Standard & Poor's Stock Reports* rates the stock "accumulate," figuring it's too cheap by 10% to 15%. Apache's forte is buying miscellaneous oil and gas properties being cast off by the oil giants. It reengineers the fields to boost production. This year, it bought properties from BP in the Gulf of Mexico and the North Sea. In turn, Apache's production in the second quarter rose from a year earlier by 26%, twice the industry average. "They're great at acquiring, and they get more out of the wells than most people," says Zock.



A Rich Haul From Bond Sales

Like most other investors, Richard Steinberg of Steinberg Global Asset Management knows the bottom line on any stock is whether you trust its management. That's one reason he likes insurer Odyssey Re (ORH). Its execs make protecting shareholder wealth a priority over grabbing a few pennies of quarterly earnings. In the second quarter of this year, they gave up some \$3 million in investment income by selling \$600 million worth of high-grade bonds and putting the money into low-yield, short-term instruments. They got top-of-the-market prices, selling right before bonds tumbled, and piled up \$1.5 billion in cash—allowing them to write more insurance at a time when pricing is strong and weaker rivals are backing away. Odyssey's book value per share is up to \$20, so the stock is a bargain at 21, says Steinberg. The p-e is just 13, based on analysts' estimates of 2003 earnings. Steinberg is buying shares and says they could go to 30 in a year. William Yankus, an analyst at brokerage Fox-Pitt Kelton, has raised the stock to a buy.

Gene Marcial is on vacation.



BusinessWeek online

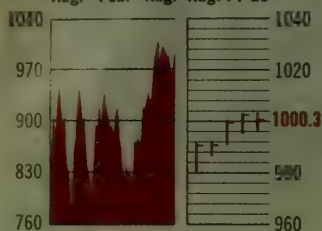
Read Gene Marcial's Inside Wall Street Online monthly column at www.businessweek.com/today.htm. And see him Fridays at 1:40 p.m. EST on CNN's *The Money Gang*.

BusinessWeek Investor FIGURES OF THE WEEK

STOCKS

S&P 500

Aug. Feb. Aug. Aug. 14-20



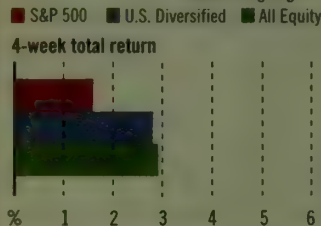
COMMENTARY

In a week marked by a Northeast blackout, equities shone brightly. Good news on chip sales sent shares of Dow component Intel higher. Both the Dow and the NASDAQ Composite hit 2003 highs on August 19, before retreating the next day. For the week, the NASDAQ, the S&P 500, and the Dow were up 4.4%, 1.7%, and 1.4%, respectively.

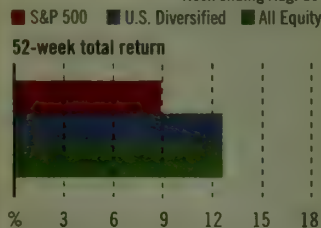
Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

Week ending Aug. 19



Week ending Aug. 19



Data: Standard & Poor's

U.S. MARKETS

	AUG. 20	WEEK	YEAR TO DATE	LAST 12 MONTHS
S&P 500	1000.3	1.7	13.7	6.7
Dow Jones Industrials	9397.5	1.4	12.7	5.9
NASDAQ Composite	1760.5	4.4	31.8	27.9
S&P MidCap 400	507.8	3.2	18.1	12.3
S&P SmallCap 600	241.2	4.4	22.7	17.8
Wilshire 5000	9671.3	2.0	15.9	9.4

SECTORS

	AUG. 20	WEEK	YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	582.4	0.7	6.1	-1.2
BW Info Tech 100**	291.8	3.0	9.2	5.9
S&P/BARRA Growth	504.6	1.7	12.4	4.3
S&P/BARRA Value	492.1	1.6	15.0	9.3
S&P Energy	197.4	0.6	7.8	4.3
S&P Financials	343.2	0.8	15.6	7.3
S&P REIT	104.2	1.3	14.7	10.9
S&P Transportation	179.0	0.7	5.3	0.9
S&P Utilities	105.8	0.7	8.2	-2.4
GSTI Internet	131.3	8.0	75.8	86.1
PSE Technology	612.5	4.7	33.6	28.9

*Mar. 19, 1999 = 1000

**Feb. 7, 2000 = 1000

BEST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Gold Mining	23.4	Internet Software 144.4
Divsfd. Metals & Mining	19.6	Wireless Services 82.7
Home Entertainment	16.4	Internet Retail 82.7
Diversified Machinery	15.2	Divsfd. Metals & Mining 65.0
Aluminum	14.4	Diversified Machinery 58.2

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS			
Precious Metals	16.8	Precious Metals	45.7
Japan	7.3	Technology	30.7
Pacific/Asia ex-Japan	6.5	Communications	28.3
Diversified Pacific/Asia	6.3	Latin America	27.4
LAGGARDS			
Health	-1.5	Japan	3.5
Utilities	0.2	Utilities	6.7
Financial	0.9	Large-cap Blend	7.4
Domestic Hybrid	0.9	Diversified Pacific/Asia	7.5

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS			
ARK Intl. Equity Instl.	27.6	PFds. Internet UHS. Inv.	149.8
PFds. Pr. Mtls. U. Inv.	23.6	Jacob Internet	137.3
Scudder Gold & Pr. Mts. S	23.0	Amerindo Technology D	93.0
U.S. Gl. Wld. Pr. Minls.	19.2	Fidelity Adv. Lvkd. Co. A	81.7
LAGGARDS			
American Heritage	-22.2	Rydex Dynam. Vent. 100	-56.8
Apex Mid Cap Growth	-10.2	PFds. UHS. OTC Inv.	-56.6
PFds. Pharma. UHS. Inv.	-7.2	Potomac OTC/Short Inv	-32.2
Rydex Dynam. Vent. 100	-7.2	Rydex Arktos Inv	-30.0

GLOBAL MARKETS

	AUG. 20	WEEK	% CHG. YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	968.8	0.7	14.7
London (FT-SE 100)	4217.4	0.9	7.0
Paris (CAC 40)	3280.3	2.3	7.1
Frankfurt (DAX)	3501.2	3.0	21.0
Tokyo (NIKKEI 225)	10292.1	5.5	20.0
Hong Kong (Hang Seng)	10475.3	1.7	12.4
Toronto (S&P/TSX Composite)	7491.1	1.6	13.3
Mexico City (IPC)	7460.2	1.2	21.8

FUNDAMENTALS

	AUG. 19	WK. AGO
S&P 500 Dividend Yield	1.65%	1.65%
S&P 500 P/E Ratio (Trailing 12 mos.)	28.5	28.1
S&P 500 P/E Ratio (Next 12 mos.)*	17.1	16.9
First Call Earnings Revision*	-0.32%	0.42%

TECHNICAL INDICATORS

	AUG. 19	WK. AGO
S&P 500 200-day average	916.5	914.3
Stocks above 200-day average	78.0%	76.0%
Options: Put/call ratio	0.66	0.75
Insiders: Vickers NYSE Sell/buy ratio	3.68	3.74

WORST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Health-Care Services	-9.6	Health-Care Facilities 10.1
Commercial Printing	-8.8	Tires & Rubber 10.1
Pharmaceuticals	-7.7	Tobacco 10.1
Office Electronics	-6.7	IT Consulting 10.1
Multi-Utilities	-5.3	Multi-Utilities 10.1

INTEREST RATES

KEY RATES

	AUG. 20	WEEK AGO	YE
MONEY MARKET FUNDS			
90-DAY TREASURY BILLS	0.63%	0.63%	
2-YEAR TREASURY NOTES	1.80	1.82	
10-YEAR TREASURY NOTES	4.44	4.56	
30-YEAR TREASURY BONDS	5.29	5.45	
30-YEAR FIXED MORTGAGE†	6.37	6.38	

†Banks' Quotes

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
GENERAL OBLIGATIONS	4.06%	4.06%
TAXABLE EQUIVALENT	5.80	5.80
INSURED REVENUE BONDS	4.17	4.17
TAXABLE EQUIVALENT	5.96	5.96

THE WEEK AHEAD

EXISTING HOME SALES Monday, Aug. 25, 10 a.m. EDT ► Existing home sales in July probably rose to an annual rate of 5.9 million, from 5.8 million in June. That's based on the median forecast of economists surveyed by MMS International.

DURABLE GOODS ORDERS Tuesday, Aug. 26, 8:30 a.m. EDT ► New orders for durable goods most likely climbed 0.8% in July.

CONSUMER CONFIDENCE Tuesday, Aug. 26, 10 a.m. EDT ► The Conference Board's August confidence index is forecast to have improved to 78.8, from 76.6 in July.

NEW RESIDENTIAL SALES Tuesday, Aug. 26, 10 a.m. EDT ► New single-family home sales in July probably slowed slightly to an annual rate of 1.13 million.

GROSS DOMESTIC PRODUCT (REVISED) Thursday, Aug. 28, 8:30 a.m. EDT ► The Commerce Dept.'s second look at second-quarter economic activity is expected to show real GDP grew at an annual rate of 2.9%, from an initial level of 2.4%. Aftertax corporate profits very likely rose by 4.8%.

PERSONAL INCOME Friday, Aug. 29, 8:30 a.m. EDT ► Personal income in July proba-

bly rose 0.3% for a second straight month. Personal expenditures most likely grew 0.8%, after a 0.3% increase in July.

The BusinessWeek production index slipped the week ended Aug. 9 to 199.9, up 2.3% a year ago. Before calculation of the four-moving average, the index fell to 197.7.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra

Index to Companies

This index gives the starting page for a story or feature with a significant focus on a company. Most subsidiaries are indexed under their own names; those listed only in tables are not included.

Salomon 100
 Sars (RKY) 54
 Sars (AGE) 12
 Sars 44
 Sars (ALOY) 94
 Sars (AMZN) 77,
 Express (AXP) 68
 Research Group
 Sars (AMTD) 94
 Warner (AOL) 20,
 Sars (PA) 101
 Sars (consumer)
 Sars 50
 Sars (records) 12
 Sars (computer) 46
 Sars 14
 Sars (ADSK) 77
 Sars (AZO) 96
 Sars (Mitsubishi)
 Sars 40
 Sars (BSC) 80
 Sars (BLS) 96
 Sars (Hathaway) (BRK)
 Sars.com 43
 Sars.com 43
 Sars (BDK) 50
 Sars (FD) 38
 Sars 43
 Sars (SAM) 54
 Sars Consulting Group
 Sars (Brewing) 54
 Sars 11
 Sars (others) 66
 Sars 91
 Sars (Nemer Fields &
 Sars 52
 Sars (ELY) 100
 Sars (management)
 Sars 101

Cerberus Capital
 Management 12
 Changhong Electric 50
 Children's Place Retail
 Stores (PLCE) 38
 Chrysler (DCX) 24
 Citigroup (C) 12, 45
 Clayton Homes (CMH) 12
 Coca-Cola (KO) 44
 Comcast (CMCSK) 36
 Compaq Computer 46
 Computer Associates (CA)
 83
 Conesco (CNCEQ) 82
 Cordiant (CDA) 12
 Cortex Pharmaceuticals
 (COR) 58
 Credit Suisse First Boston
 (CSR) 68
D
 Datek 94
 DC Capital Partners 82
 Dell (DELL) 46, 77, 80
 Deloitte & Touche 34
 Digital Insight (DGIN) 94
 Donaldson Lufkin Jenrette
 (CSR) 68
E
 eBay (EBAY) 94
 Elan Pharmaceuticals
 (ELN) 58
 Electrolux (ELUX) 50
 Electronic Data Systems
 (EDS) 44
 EMC (EMC) 40
 Enron (ENRNQ) 52, 82
 Ericsson (ERICY) 44
 Ernst & Young 34
 Erste Bank 44
 Expedia 94
F
 Fila (FLH) 12
 FindWhat.com (FWHT) 94
 First Union 68
 Flextronics International
 (FLEX) 44
 FLIR Systems (FLIR) 101
 Ford (F) 24
 Formica 12
 Fortune Brands (FO) 100
 Fox-Pitt Kelton 101

Franklin Electronic
 Publishers 98
G
 Gap (GPS) 38
 Garmin (GRMN) 99
 Gateway (GTW) 46
 General Electric (GE) 36
 General Motors (GM) 24,
 44, 50
 GlaxoSmithKline (GSK) 40
 Goldman Sachs (GS) 80
 Golf Datatech 100
 Guidant (GDT) 40
H
 Haier Group 50
 H&M Hennes & Mauritz 38
 Harbour & Associates 24
 Hasbro (HAS) 22
 HealthSouth 83
 Helicon Therapeutics 58
 Hewlett-Packard (HPQ) 46,
 80
 Home Depot (HD) 40, 50
I
 IBM (IBM) 44, 77
 Icahn Associates 83
 IndyMac Bancorp (NDE) 94
 InsightExpress 91
 Intel (INTC) 50
 InterActive (IACI) 94
 Inventec 46
J
 J.D. Power & Associates 24
 Jenkins & Gilchrist 52
 JMP Securities 101
 Johnson & Johnson (JNJ)
 40, 58
 Jos. A Bank Clothiers
 (JOSB) 66
 J.P. Morgan Securities
 (JPM) 25
K
 Kmart (KMRT) 82
 KPMG 34
 Kraft Foods (KFT) 12, 16
L
 leapfrog.com 98
 Legg Mason 12
 Lehman Brothers (LEH) 68
 LendingTree (TREE) 94

Lenovo 50
 Les Laboratories Servier 58
 LG Electronics 50
 Liberty Media (L) 36
 Lite-On Electronics 46
 L.L. Bean 66
 Lowe's (LOW) 40
 Lycos 82
M
 MarketPerform.com 12
 Maverick Capital 83
 McGraw-Hill (MHP) 28
 MCI 82
 MDM Bank 45
 Memory Pharmaceuticals
 58
 Merrill Lynch (MER) 12, 68
 Merz 58
 Microsoft (MSFT) 44, 77
 MicroStrategy (MSTR) 34
 Mitac International 46
 Monster Insight (MNST) 94
 Moody's Investors Service
 (MCO) 24
 Morgan Stanley (MWD) 12,
 46, 86
 Motorola (MOT) 50
N
 Navis 77
 NBC (GE) 36
 NEC (NIPNY) 46
 Network Appliance (NTAP)
 40
 Network Associates (NET)
 94
 New England Consulting
 Group 66
 News Corp. (NWS) 36
 Nike (NKE) 100
 Nissan (NSANY) 24
 Nokia (NOK) 40
 Northwest Airlines (NWAC)
 40
 Novartis (NVS) 58
 NP Group 66
O
 Odyssey Re (ORH) 101
 onClick 20
 Oracle (ORCL) 77
 Orbitz 94
 Overture Services (OVER)
 94

P
 Panasonic (MC) 46
 PeopleSoft (PSFT) 77
 Peregrine Systems 82
 Pfizer (PFE) 40, 58
 Philips Electronics (PHG)
 50
 Pinnacle Airlines 40
 Platts Research &
 Consulting (MHP) 28
 Premier Partners
 Investment Research 83
 Priceline.com (PCLN) 94
 PricewaterhouseCoopers
 34, 82
 Prudential Financial (PRU)
 12, 68
 PSA Peugeot-Citroën 44
Q
 Quadrangle Group 82
 Quanta Computer 46
 Quicken (INTU) 20
R
 Raiffeisen Bank 45
 Ranger Partners 83
 RealNetworks (RNWK) 94
 Redback Networks (RBAK)
 40
 Redhook Brewing 54
 Register.com (RCOM) 94
 Retail Forward 66
 R.J. Reynolds (RJR) 40
 Robert W. Baird 68
 Roche Holdings 58
 Rosbank 45
 Royal Philips Electronics
 (PHG) 44
S
 Saegis Pharmaceuticals
 58
 Salesforce.com 77
 Salomon Smith Barney (C)
 68
 Samsung 46
 Sany Heavy Industry 50
 Schneider Electric 44
 Second Curve Capital 68
 Security First 20
 Shanghai Automotive
 Industry 50
 Siebel Systems (SEBL) 77
 Siemens (SI) 50
 Smith & Carson 86

Société Générale 45
 Sony (SNE) 20, 36, 46, 98
 Southern (SO) 28
 Standard & Poor's (MHP)
 46
 Steinberg Global Asset
 Management 101
 SunGard Data Systems
 (SDS) 77
 Symantec (SYMC) 94
T
 Taiwan Ratings 46
 Talbots (TLB) 66
 Targus 20
 TCL International Holdings
 50
 Telemundo
 Communications Group
 36
 Thomson First Call 101
 Top-Flite Golf 100
 Toyota (TM) 24, 44
 Troika Dialog 45
 T. Rowe Price (TROW) 101
 Tumi 91
 Tyco International (TYC) 34
U
 UAL (UAL) 82
 UBS Investment Bank
 (UBS) 77
 UBS PaineWebber (UBS)
 68
 UpShot 77
 USG (USG) 82
V
 VeriSign (VRSN) 94
 Verizon Communications
 (VZ) 16
 Viacom (VIA) 36
 Vivendi Universal (V) 36
W
 Wachovia (WB) 68
 Wal-Mart Stores (WMT) 38
 Walgreens (WAG) 96
 Wilmer Cutler & Pickering
 52
Z
 Ziba Design 50

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STOP BICKERING AND FIX THE POWER GRID

The blackout of 2003 did more than cut off the lights for 50 million people. People couldn't use their computers to get to the Internet. They couldn't reach their children and friends on cell phones. The August power outage hit whole systems of information, communication, and safety. That's because we have created an information society that depends on highly complex, networked, and interconnected technological systems—and we are not managing them at all adequately. Indeed, they are increasingly run not on the basis of science or engineering but on ideological preferences, not for the overall public good but for regional or parochial interests.

The blackout is merely the latest and most dramatic example of this trend. For years, engineers, regulatory agencies, utilities, businesses, and consumer groups warned that the transmission grid needed upgrading. The U.S. was shifting from a regional system of regulated monopolies to a more deregulated national market for electricity, and the grid required uniform, national rules of the road and more capital investment. Simple problem to address, right? Yet the solution has been defined in political terms, as being for or against states' rights, or pro- or anti-deregulation. Fixing the grid has never been seen simply in terms of getting it to work better.

Texas and states in the Southeast and the Northwest continue to keep their electricity regulated and don't want Washington telling them what to do. Northern and Midwestern states that did deregulate want the federal government to set uniform rules for the grid so they can buy and sell their electricity in a well-functioning national market. Both sides have fought the issue to a standstill in Congress. And neither is willing to pay for new investments in a grid they commonly use but don't profit from—a classic case of the so-called tragedy of the commons. So as electricity usage rose sharply, the grid didn't keep up. Inevitably, it broke down. Was the blackout a failure of technology? Hardly. Blame the clash of ideologies.

SHORT-TERM THINKING Ideology has also paralyzed the White House's attempt to pass a broad energy policy for the nation. With oil at more than \$30 a barrel still taxing consumer spending power, the economic cost of gridlock is high. Conservatives want measures to encourage drilling for oil and gas to increase supplies. Liberals focus mostly on conservation and cutting down on the demand. Clearly, the country needs both in a balanced energy package. Yet it can't get there because of partisan bickering.

Blame politics as well for the failure of the cell-phone system when the lights went out. Well before batteries ran down in Detroit, New York, and other cities, people could not use their cells. That had nothing to do with wireless phone technology. In the old days of AT&T, the regulated monopoly was required to build redundancy into the system, so that in an emergency there would be surplus capacity to get calls

through. AT&T passed the extra cost along to customers in the deregulated world of cell phones, no redundancy required, and there's no incentive to provide any. Telecom companies plan on no more than 20% to 30% of their customers using their phones at one time. But as September 11 showed, this is nonsense in an era of security threats.

Deregulated telecom companies are not about to build in redundant capacity for national emergencies. They respond to the market's short-term incentives to make a profit, as they should. Nor do they want to charge customers extra for the equipment necessary for coping in a crisis. Washington, for its part, doesn't want to raise taxes for surplus cell-phone capacity and won't order the telecommunications companies to invest and pass the charge to customers (as it does do, for example, when it orders the industry to subsidize rural telephone users). The failure of cell phones during the blackout had nothing to do with technology itself, but only with how we manage it. The phone companies are obeying the clear market forces of deregulation. Washington is following its no-tax political pressures. A simple need to build extra cell-phone capacity to deal with terrorist attacks or emergencies is not being addressed. Technological redundancy translates into reliability and security. The question of who will pay for it is a political issue no one dares address. So we remain vulnerable to terrorism and accidents alike.

PRAGMATISM, PLEASE Certainly, there are serious scientific issues surrounding the rise of more complicated technological systems that need to be discussed. Should they even try to operate a single, centralized electricity system? One giant, deregulated market for electricity across the country would tend to provide the most efficient and lowest cost electricity to consumers and businesses. But it would also reduce reliability, since everyone would be dependent on one system all the time, and systems do crash. Widespread blackouts have huge economic costs that must be measured against the savings of a unified, deregulated market. A more regional, decentralized electricity system, managed by a national grid but producing most power locally, might be more rational, especially in an age of insecurity.

In the current atmosphere, however, we may never get there. By replacing pragmatism with ideology and practicality with politics, we are undermining the foundation of our information society. Our ability to deal objectively with inevitable problems that arise from technology is slowly being eroded. The very basis of America's future growth rests on the idea of a wired, networked knowledge economy. But the blackout of 2003 reminds us of the fragility of that idea and how perilously close we are to the terror of finding ourselves isolated and defenseless in the dark. We must find ways to set aside partisan politics and ideological zealotry to fix what needs fixing. The nation's prosperity and security depend on it.

September 8

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**Crippling
computer
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Can
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*OnStar services require vehicle electrical system and analog wireless service to be available and operating for features to function properly. Visit www.onstar.com for system information and details. **Testing conducted by the National Highway Traffic Safety Administration (NHTSA) as part of its New Car Assessment Program (NCAP)

BusinessWeek

SEPTEMBER 8, 2003



Cover Story

28 EPIDEMIC

Crippling viruses—such as the recent SoBig and MSBlast—are more than just a nuisance. They threaten the whole information economy. And as they get more destructive, experts worry that terrorists may get interested. How should companies, government, and individuals battle this pestilence?

32 THE VIRUS HUNTERS

Some 500 cyber-sleuths struggle to keep tabs on more than 10,000 virus creators worldwide

36 COMMENTARY: SPAM

To reclaim e-mail as a prodigious productivity tool, drastic measures are needed

38 COMMENTARY: SOCIETY

High-tech systems are too complex and too centralized. Simplify them before it's too late

News: Analysis & Commentary

40 COMMENTARY: SONG PIRACY

In the coming war against digital downloaders, the recording industry has all the firepower

41 TERRORISM IN THE HOMELAND

The shadowy Earth Liberation Front is proving hard to stop

42 COMMENTARY: FREDDIE MAC

Will Freddie and Fannie's new chaperone get tough?

44 WARREN BUFFETT HITS A BUMP

A judge has put his deal to take over Clayton Homes on hold

46 IN BUSINESS THIS WEEK

International Business

50 EUROPE: THE ECONOMY

Without significant structural reforms, the recovery won't stick

52 IRAQ: TELECOMMUNICATIONS

Will non-U.S. telcos get a chance to build a mobile phone network?

54 HONG KONG: THE ECONOMY

Beijing is lavishing it with economy-boosting measures

56 INTERNATIONAL OUTLOOK

Trade talks: Can the rich keep the poor on board?

Economic Analysis

24 ECONOMIC VIEWPOINT

Kuttner: The great American pension-plan robbery

25 BUSINESS OUTLOOK

U.S.: The jumpy bond market should take a chill pill
Australia: Addressing horror

Government

49 WASHINGTON OUTLOOK

Why California's raging rebellion burn Bush

Marketing

68 WAKING UP HEINEKEN

Earnings are flat. Beer down. Can it get growth going again?

72 THE HOUSE THAT FREDDY

Alfred Heineken died in 2001, but his influence is still felt keenly

People

76 PLAYING GOOD COP TO MU

How Peter Chernin oils the wheels as No.2 at News Corp.

The Corporation

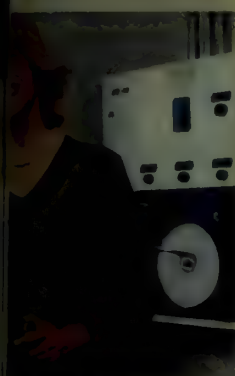
78 FORD'S TRIAL BY TRUCK

The F-150 is full of goodies. But profit relief may be temporary as the truck unit faces a burn

ER STORY

IC

mer spate of
ks show
vast potential
nem. Can they
ed? page 28



MELD

a Francisco is
ch innovation
ne page 102

ace

TURN FOR THE UAW?

onization efforts in the car parts
stry are paying off. Next
get: Foreign-owned car plants

ries

LOW BURNS UP THE ROADWAY

low Corp.'s CEO explains the
ategy behind his merger with
ger rival Roadway

BRIGHTER GLOW ON NUCLEAR?

y the Blackout of 2003 may give
resh charge to this steady source
electricity

ce

COMMENTARY: WALL STREET

called independent research
ns have their own conflicts of
erest

THE LATEST ACCOUNTING MAGIC

ntingent convertible bonds are
the rage on Wall Street but
e hidden costs for shareholders

CK REGAINS ITS LUSTER

h corporate scandals fading, the
ropean high-yield bond market
come back with a vengeance

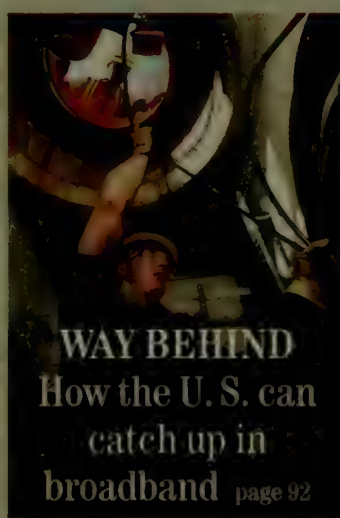


DUTCH THREAT

Heineken decides it's
time for a marketing
makeover page 68



- Man in the gray flannel...whoa! page 110
- When sharp is in the shirt page 112
- Off-the-rack, and only \$3,000 page 114
- Puzzling out DuPont's picture page 118



WAY BEHIND
How the U.S. can
catch up in
broadband page 92



'MURDOCH LITE'

Peter Chernin is
News Corp.'s amiable
No. 2 page 76



F-150 AND FIGHT

Ford's pickup isn't
apt to give profits
much of a kick page 78

Information Technology

18 WILDSTROM: TECHNOLOGY & YOU

How computer owners can combat
viruses on their home turf

92 COMMENTARY: BROADBAND

Providers and the feds will have to
work together to stop the U.S.
from falling further behind

96 COVAD: BACK FROM THE DEAD

The boom-era telecom is making
headway under CEO Hoffman

Science & Technology

98 SHOCK THERAPY'S NEW JUICE

It's now a widely accepted
treatment for severe depression,
though some controversies remain

102 A BIOMEDICAL POWERHOUSE

The University of California at San
Francisco has become a world-class
showcase for innovation

105 DEVELOPMENTS TO WATCH

The point-and-shop cell phone;
a gel that will repel AIDS;
don't sweat the mercury in fish

BusinessWeek Investor

109 DIVIDENDS

Pension fund profits; disposable
digital cameras; wireless RV parks

110 DRESS SMART

The latest male business wardrobe
updates classics with modern fabrics

112 WHAT A NEW SHIRT WILL DO

Luxurious pairings and accessories
can freshen up an old suit

114 WHY A \$3,000 SUIT?

Ready-made garments from Brioni
and Oxxford feel plenty bespoke

118 THE BARKER PORTFOLIO

Would a low-fiber DuPont be just
as appetizing?

121 MARCIAL: INSIDE WALL STREET

Features

8 UP FRONT

12 READERS REPORT

13 CORRECTIONS & CLARIFICATIONS

16 BOOKS

Tett: *Saving the Sun: A Wall Street
Gamble to Rescue Japan from Its
Trillion-Dollar Meltdown*

122 FIGURES OF THE WEEK

127 INDEX TO COMPANIES

128 EDITORIALS

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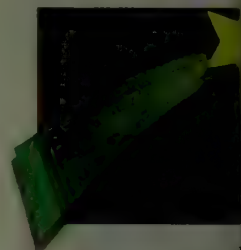
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What will they think of next?



Up Front

EDITED BY IRA SAGER



**DORMAN:
A MATTER
OF VALUE**

THE DEAL MILL

CROSSED WIRES IN TELECOM TALKS

ONE OF THE LONGEST-RUNNING acquisition talks in telecom has hit a snag. AT&T and BellSouth, which have been in intermittent discussions for nearly two years, are bogged down over price, *BusinessWeek* has learned. An executive familiar with the talks says AT&T CEO David Dorman believes the long-distance giant should sell for about \$25 a share, a 16% premium over its current price of \$21.56. That would put a deal at around \$20 billion. BellSouth maintains AT&T is fairly val-

ued and is only willing to pay a small premium over its \$17 billion market cap.

Is the dance finally over? BellSouth is showing interest in other targets. There are plenty of cheap telecom assets on the market, and some BellSouth execs think they see better values than AT&T. For example, BellSouth could try to acquire some or all of MCI, which is expected to emerge from bankruptcy this fall. MCI operates Internet powerhouse UUnet. That could improve BellSouth's ability to serve corporate clients. "There have been talks about UUnet," says a person familiar with the discussions. But those talks haven't gone anywhere.

It could be some time before a move is made. The industry is on a more stable footing than last year, and companies are betting they will be worth more tomorrow than they are today. AT&T, BellSouth, and MCI declined comment. *Steve Rosenbush*

LITIGATION NATION

ASBESTOS' DAY IN COURT

GOT A PROBLEM WITH ASBESTOS-reform legislation? Tell it to the judge. In a highly unusual move, Senator Arlen Specter (R-Pa.) has tapped a federal judge to informally mediate a proposed \$145 billion settlement, *BusinessWeek* has learned.

The bill has been stalled since July 10, when a Senate panel passed a revision that widened the conflicts among labor, plaintiff's lawyers, cor-



ASBESTOS: On trial?

porations, and insurers. At Specter's urging, all sides met on Aug. 18 and 19 with Judge Edward Becker of the Third Circuit Court of Appeals. The atmosphere, say several participants, was chilly. Specter's office did not

return calls.

The judge's ruling? All he would say: "It was a productive meeting." Becker has asked all parties to file written comments by Aug. 29. Top Senate aides say Becker is free to weigh in all he wants, but lawmakers have no intention of ceding authority to the judicial branch. *Lorraine Woellert*

TALK SHOW "The company lied. These employees lied. Law was broken. It's just that simple."

—Oklahoma Attorney General Drew Edmondson, filing criminal charges against WorldCom and ex-CEO Bernie Ebbers

QUID PRO QUO?

FUZZY FOCUS ON POLAROID'S AUCTION

BURIED IN A 106-PAGE REPORT by an accountant who spent six months investigating charges of fraud related to the October, 2001, bankruptcy of Polaroid is an unanswered question: Did top execs favor the buyer, One Equity Partners, in exchange for jobs and shares in the company?

On Aug. 22, court-appointed examiner Perry Mandarino issued his report, finding that "it appears around the time of the auction [of Polaroid assets] at the latest," OEP planned to give Polaroid managers shares in the new company. But the investigation was inconclusive. "No one could remember when it was first discussed," says Mandarino. Such a relationship would be

fraud if it occurred before auction, says UCLA law professor Lynn LoPucki.

Shareholders aren't to accept the report's findings. On Aug. 26, investors filed a lawsuit claiming the company's auditors, KPMG, misled three top execs and investors. "Clearly, we think fraud has occurred," says Stephen Morgan, a Polaroid investor. KPMG says it

received the report and could comment.

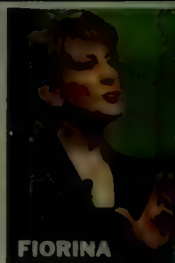
Eight former Polaroid executives, including CFO, own 4% of the new company. Polaroid named in shareholders

but says the auditor's report resolves any questions surrounding its \$255 million. A spokesman for OEP, private-equity arm of Bank of America, says managers typically have a stake in the new company and that talks started months after the sale. *Faith*



THE LIST ITCHIN' FOR A FIGHT

On Aug. 19, Hewlett-Packard posted embarrassing results because of trouble in its PC business. A day later, rival Dell slashed prices on PCs and servers by as much as 22%. Dell left little doubt it's calling out HP. The tale of the tape:



FIORINA



DELL

	MARKET SHARE		AND THE EDGE GOES TO...
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PCs	16%	18%	DELL Low costs and nimble pricing make Dell the master of this domain.
PRINTERS	40%	<1%	HP Dell's printers are priced right, but HP has snazzy new designs and innovative technology.
HANDHELD PCs	15%	5%	HP Outmoded products and technical glitches are slowing Dell's assault on HP's iPaq.
SERVERS	28%	9%	DELL HP is No. 1, but it's losing money and market share.

CONTRIBUTED BY ANDREW FARM

Data: Gartner Inc.



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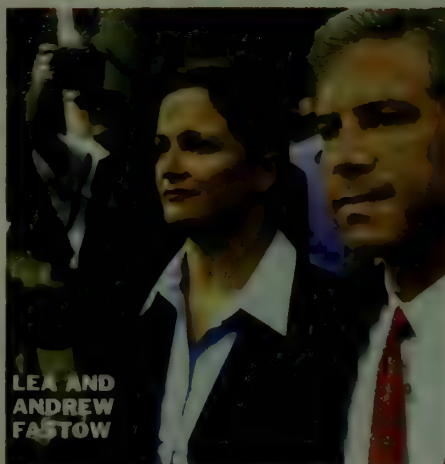


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Up Front



ENRON WATCH

SLOWING DOWN THE FASTOW TRIAL

THE FIRST TRIAL OF A FORMER Enron employee is being delayed—and the defense has the Super Bowl to thank.

Lea Fastow, previously Enron assistant treasurer and wife of former CFO Andrew Fastow, has pleaded not guilty to money laundering,

filing false tax returns, and conspiracy. Jury selection was to begin on Jan. 27, 2004, but with the Super Bowl in Houston on Feb. 1, the trial could have been a logistical mess, Fastow's lawyers said. Hotels are already booked up. Says defense lawyer Mike DeGeurin: "The government would benefit as much as anybody"

by the delay, since the prosecution will no longer have to make its case during distracting festivities. The trial now starts on Feb. 10.

The defense was hoping for a longer reprieve. Lea's lawyers had been trying to get her trial postponed until after her husband's. They argued that his testimony could help his wife, but that he had to wait until after his trial to protect his rights against self-incrimination. So much for chivalry. *Wendy Zellner*

AFTERLIVES

FROM NETSCAPE TO THE SEASCAPE

THE TECH INDUSTRY MAY BE starting to rebound, but it will have to revive without the help of Silicon Valley serial entrepreneur Jim Clark. The founder of Silicon Graphics, Netscape, and Healtheon has sworn off the Valley. "It's in such a funk," he says.

Instead, Clark has turned his attention to Miami, where

he now resides. With fellow tech veteran Thomas Jeromuk, former chairman of Excite@Home, he has formed a real estate firm, Hyperion Development Group. Their first project under construction is a 330-unit condo on Miami's Biscayne Bay. Apartments in the curvilinear 36-story building, made of steel and blue glass, have views on both sides.

While Clark has left Silicon Valley, he hasn't left risk behind. Miami's Biscayne area is something of an urban renewal project. It's not clear the neighborhood will support \$700,000 condos. Still, Clark is happy trying something new. "We're developers now," he laughs. "We've gone back to making money the old-fashioned way." If Clark has anything like the success he had in tech, where he amassed a fortune of nearly \$2 billion, you can expect to see Hyperion projects sprouting all over South Florida. *Steve Hamm*



CLARK: Miami condo mogul

DRAWN & QUARTERED



FOODSTUFF

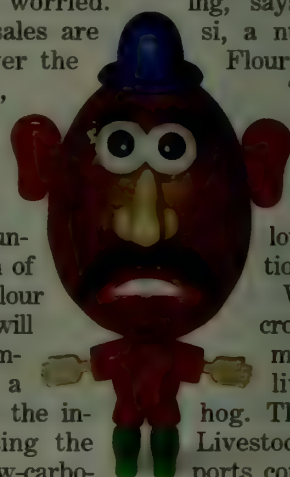
STARCH IS ON THE MARCH

THE LOW-CARB ATKINS DIET has become so popular in Britain that producers of starchy food are worried. Although bread sales are down just 2% over the past three years, the food industry isn't taking any chances.

On Sept. 23, the British Potato Council, the Federation of Bakers, and the Flour Advisory Bureau will hold a "Carbo Summit" to unveil a study—funded by the industry—highlighting the health risks of low-carbohydrate diets. The Potato Council is spending \$1.6 million on marketing, including a

bus tour traveling the country passing out potatoes. October, a.k.a. British Month, the Federation of Bakers will use retail promotions to try to boost bread's sales as low-fat. "People think bread and potatoes as fattening," says Tamara de la Torre, a nutritionist at the Flour Advisory Bureau.

"But carbohydrates provide important nutrients. Atkins offends people who say their diets are realistic," she says. While the health of the crowd is hurting, the meat producers are living high on hog. The U.K. Meat and Livestock Commission reports consumption rose to a record 4.3 million tons a year, up from 4.2 million a year ago. *Laura*



THE BIG PICTURE

NIP AND TUCK

While FDA approval has led to a surge in Botox injections, the number of cosmetic surgeries decreased 12% in 2002. Some of the most common:

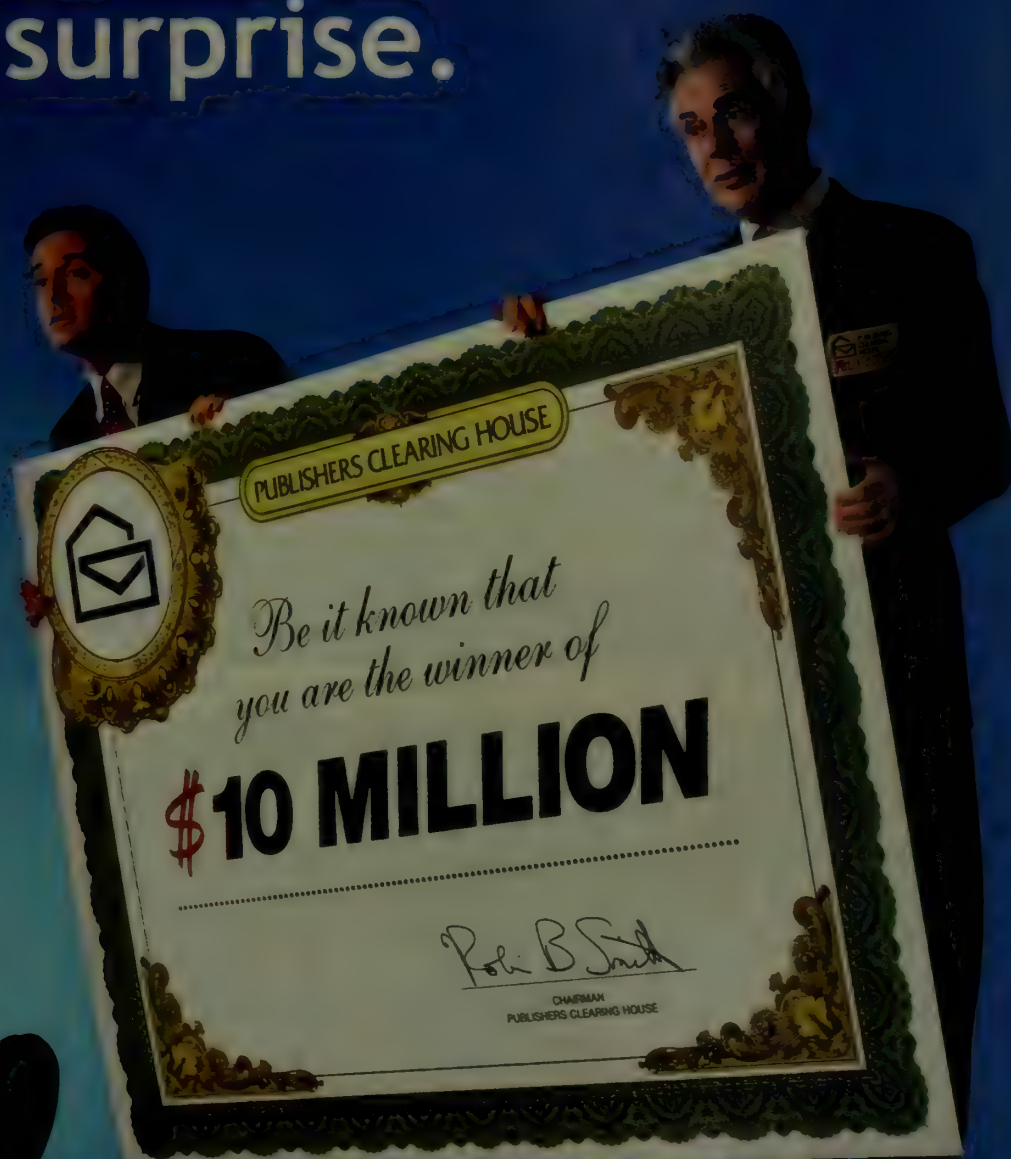
PROCEDURE	MILLIONS PERFORMED	
	2002	2001
BOTOX	1.1	0.8
CHEMICAL PEEL	0.9	1.3
MICRODERMABRASION	0.9	1.0
LASER HAIR REMOVAL	0.6	0.7
COLLAGEN INJECTIONS	0.6	0.8

Data: American Society of Plastic Surgeons



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WHAT NASDAQ HAS IN THE PLUS COLUMN

"NASDAQ: The fight of its life" (Cover Story, Aug. 11) sensationalized the facts to an extent that one could believe the NASDAQ might go the way of the dodo bird. Sure, the crash of high-tech stocks vastly reduced the demand for the typical NASDAQ stock, while competitors such as Instinet increased the amount of trading activity done away from the exchange. But newly appointed CEO Robert Greifeld recently responded with some dramatic steps, including a decision to shut down NASDAQ Europe. NASDAQ is going to focus all of its energies on winning new U.S. listings, and the fundamentals suggest that it may succeed.

However, the article underplays how the regulators have left intact blockades to NASDAQ's growth and have refused to budge from safeguarding "Rule 500," which restricts companies from delisting from the New York Stock Exchange for a listing on the NASDAQ.

Motivating regulators to change their rules is often an impossible task. But stories like yours may help the deregulatory crusade. If regulators notice that their actions create an environment where our nation's leading business magazine questions whether NASDAQ can continue to prosper, perhaps it's time for regulations to change.

Kevin A. Hassett
 Resident Scholar
 American Enterprise Institute
 Washington

While we don't agree with all aspects of *BusinessWeek's* story, we commend

the magazine's recognition of the benefits associated with NASDAQ's competitive market model. We are proud of our model because it allows us to provide lower spreads to our investors than other market system (0.7¢ in Citi Securities Inc. on NASDAQ vs. 1.4¢ in NYSE), thereby resulting in more efficient, lower-cost trading.

NASDAQ itself faces a lot of competition. It embraces healthy, competitive market forces: it is the very heart of capitalism and is what NASDAQ stands for. History has shown that competition greatly benefits the customer, resulting in better services, fair pricing, and sheer innovation. In NASDAQ's case, our ultimate

customer is the investor.

Christopher A. Conner
 Executive Vice-President
 Strategy and Business Development
 NASDAQ Stock Market
 New York

**DRUG COVERAGE:
 GOOD AND BAD PRESCRIPTION**

"Rethinking the drug business" (Cover Story, Aug. 11) was right on target in saying that the right solution to the problem of drug costs lies in the hands of the federal government. The article's concerns about the affordability of medicines is to bring "every American, especially the elderly, into a private-public health-care organization that can bargain for lower drug prices." The wrong solution is to allow the importation of medicines from Canada and other countries.

True, Americans are tired of paying more for medicines than patients in other countries where governments set the prices or use the threat of

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Corrections & Clarifications

Pass Bancshares Inc. operates 358 offices located in Sunbelt states, not 117, incorrectly stated in "Poised to survive 1-quarter doldrums" (Inside Wall Street, 11).

To Go Under the Knife—or Not?" (BusinessWeek Investor, July 7), a 1999 study of hospital patient deaths resulting from medical errors was incorrectly attributed to the National Institutes of Health. It was conducted by the Institute of Medicine of the National Academies.

citizens the best medicines to deal with below-market prices. But legalizing the practice of importing medicines would add to the already growing threat of counterfeit and adulterated medicines coming into our country, and import price controls on American medicines—whether imposed by U.S. elected officials or imported from abroad—will undermine the successful innovation model that has brought Americans the medicines that are lengthening and changing

Americans with good drug coverage need to take a bus to Canada or import medicines over the Internet. Coverage brings along the bargaining clout to reduce the cost of needed medicines. The bill supports Congress' actions to provide all seniors with access to drug coverage by passing the pending Medicare prescription drug legislation. This is the best way to provide access to medicines and maintain the incentives for pharmaceutical innovation.

Raymond V. Gilmartin
Chairman, President, and CEO
Merck & Co.
Whitehouse Station, N.J.

A COCONUT FOR YOUR TANK

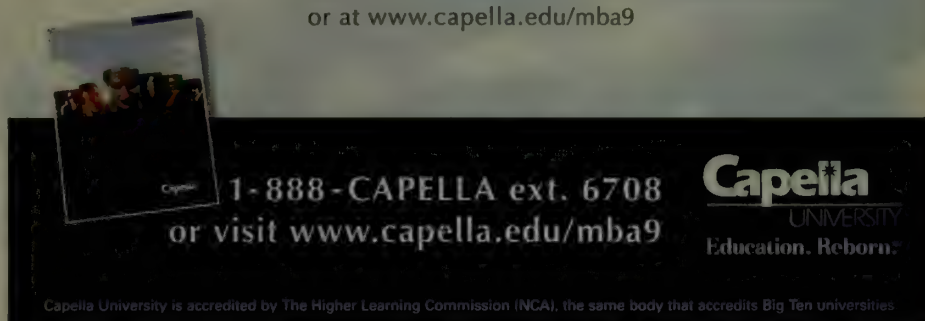
udos to FedEx Corp. and United Parcel Service Inc. ("FedEx and Brown going green," Environment, Aug. 11). This development couldn't have come at a better time for the Philippines, the world's largest coconut-oil-producing country, which has struggled for years to promote the use of "Cocodiesel" (5% blend). Cocodiesel and other green fuels will become commercially viable only through similar initiatives, and only as more companies follow the bold move by FedEx and UPS. By the way, FedEx and UPS have a

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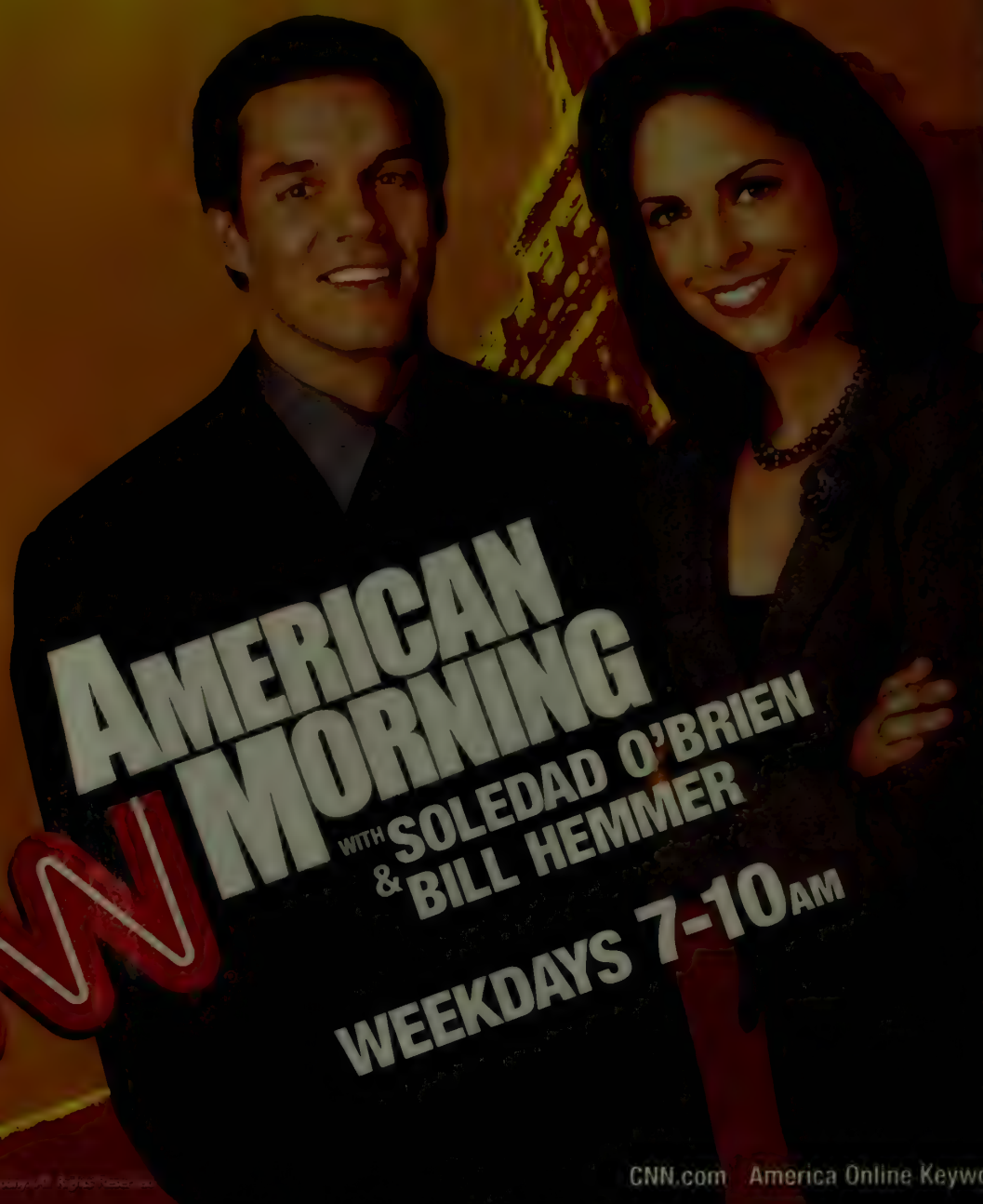


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be seeing their delivery trucks
og along on cocodiesel.

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SPAM TAX PAM

e effective way to reduce the
nt of spam is to levy a 1¢ tax on
e-mail sent ("Out, out, damned
," Legal Affairs, Aug. 11). At 1¢,
verage user is not going to incur
of a charge. But the spam opera-
who is sending e-mails to millions of
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der to make the tax revenue neu-
to the government, lower the
ommunications tax by an equal
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SAVING THE SUN

A Wall Street Gamble to Rescue Japan from Its Trillion-Dollar Meltdown

By Gillian Tett

HarperBusiness • 337pp • \$26.95

UNCOVERING THE ROT IN JAPAN'S BANKING SYSTEM

The spectacular 1998 downfall of Long Term Credit Bank of Japan Ltd. (LTCB) was a seminal event for modern-day Japanese capitalism. The Tokyo megabank lent money recklessly, engaged in a criminal cover-up, and then saw lies aplenty unravel under outside scrutiny. But that's far from the whole story. The crash revealed to the world the rot beneath Japan's bank-centric financial system, under which bankers and financial bureaucrats portioned out capital foolishly and almost never allowed overextended borrowers to fail. The practices exacted a serious toll in lost Japanese economic growth.

Now comes a smart and engaging rendering of LTCB's collapse and its messy takeover by a consortium of Western investors. *Saving the Sun: A Wall Street Gamble to Rescue Japan from Its Trillion-Dollar Meltdown*, by former *Financial Times* Tokyo bureau chief Gillian Tett isn't breakthrough reporting. But it's a riveting tale with important insights into Japan's culture and its sclerotic system.

LTCB started operations in 1953. There had been a brief attempt by U.S. occupation authorities to open up Japan's capital markets. Tokyo officialdom, though, preferred that banks be the primary channel for funneling money to industry. Specialized lenders such as LTCB were to give preferential treatment to such industries as shipping and textiles, key to economic recovery and the cultivation of overseas markets. Stocks were viewed not as investment instruments but as a way of cementing ties among big companies and banks.

During Japan's high-growth years of the 1960s and '70s, the system seemed to work brilliantly. By the late '80s, Japanese companies backed by friendly banks scared the daylight out of foreign competitors. A stock market bubble also enhanced Japanese investors' abili-

ty to buy foreign companies and real estate. The market capitalizations of Japanese banks dwarfed those of New York and London institutions. By 1989, Tett notes, LTCB's market cap was several times Citibank's, and its assets were the ninth-largest in the world.

It all ended badly. The Nikkei peaked in December of that year and crashed in 1990, setting off a bear market that lingers to this day. Next, real estate prices collapsed, savaging just about every loan book in Tokyo and Osaka. LTCB proved no exception. One of its biggest borrowers was Harunori Takahashi, a flashy real estate speculator known for making extravagant bets on resorts and golf courses across Asia. Although Takahashi had for years seemed untouchable, LTCB was forced to cut its ties with him in the mid-1990s, after his company's illegal business practices—and his habit of treating financial regulators to expensive sex-club outings—came to light. But by then, Takahashi had nearly \$2 billion in outstanding loans from LTCB, half of which went bad.

There were other disasters lurking: LTCB was carrying \$50 billion in dud loans, had no viable business model, and was too damaged to attract foreign partners with capital and managerial expertise. When Katsunobu Onogi took over as president in 1995, LTCB was in a death spiral. Tett provides an excellent description of LTCB's woes and the loan-book doctoring that eventually led to criminal convictions for Onogi and other executives.

The second half of *Saving the Sun* chronicles the effort of Wall Street money pros, led by New York private-equity firm Ripplewood Holdings LLC, to buy and revive LTCB, which had been declared

insolvent and taken over by the government. Ripplewood founder Timothy Collins pulled every string he could, knowing that the Japanese would view foreign takeover of LTCB with grave suspicion. He recruited such figures as former Fed Chairman Paul A. Volcker, ex-Chase Manhattan Bank Chairman David Rockefeller to lobby Japanese officials. A Democratic Party donor, Collins even got pal Bill Clinton to seat close to Japanese Prime Minister Ryutaro Hashimoto. Meanwhile, Collins' ally, Japanese business, such as Mitsubishi Corp. Chairman Minoru Makiyama, advised against the takeover.

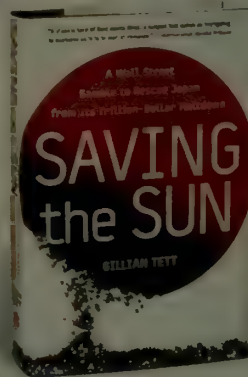
Ripplewood eventually prevailed, purchasing the highly regarded former assets of Citibank Japan, Masamoto Yashiro, to run a revamped LTCB. It would later be dubbed Shinsei, or rebirth. But the structure of the government's sale of LTCB guaranteed acrimony. Ripplewood and its backers, which included Capital and Mellon Bank, agreed to buy LTCB for a \$1.2 billion. The government assumed \$50 billion in performing loans, leaving the bank with \$110 billion or supposedly healthy assets during the three years following the bank's purchase. Any remaining loans lost in the process were more than 20% of their value. Collins insisted that the government must buy them.

Once Shinsei was up and running in 2000, Yashiro became aware of further problems. For example, giant retailer Sogo Co., which had \$19 billion in debt, wanted half of the \$1.7 billion owed Shinsei forgiven. While bailouts are common in Japan, the government would have wiped out Shinsei's capital base and profits. Yashiro said no, Sogo went under, touching off a firestorm in the Japanese Diet.

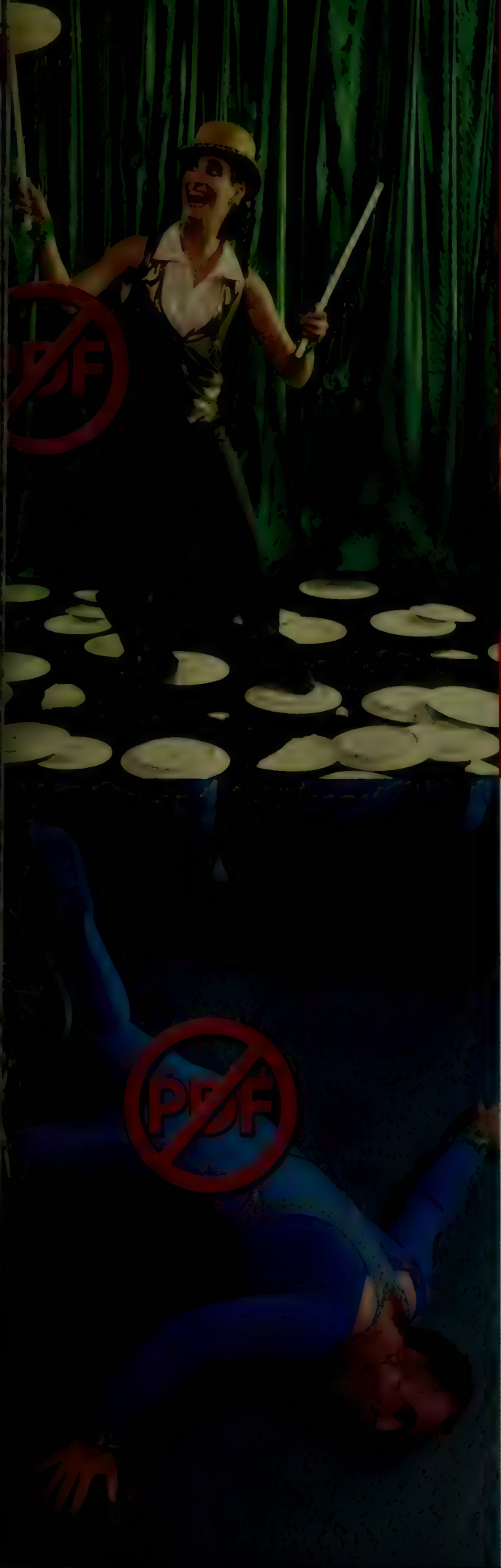
The idea that borrowers should sue when they can't repay loans still shocks Japanese. Shinsei and other foreign-owned banks, however, are starting to change that. Today, Shinsei, which branched out into retail and investment banking, is profitable and has a promising future. But as Tett shows, the East-West cultural divide still yawns wide.

BY BRIAN BREMER

Bremner is Tokyo bureau chief.



LONG TERM CREDIT BANK HAD \$50 BILLION IN DUD LOANS, OFTEN BAILING OUT STRAPPED BORROWERS



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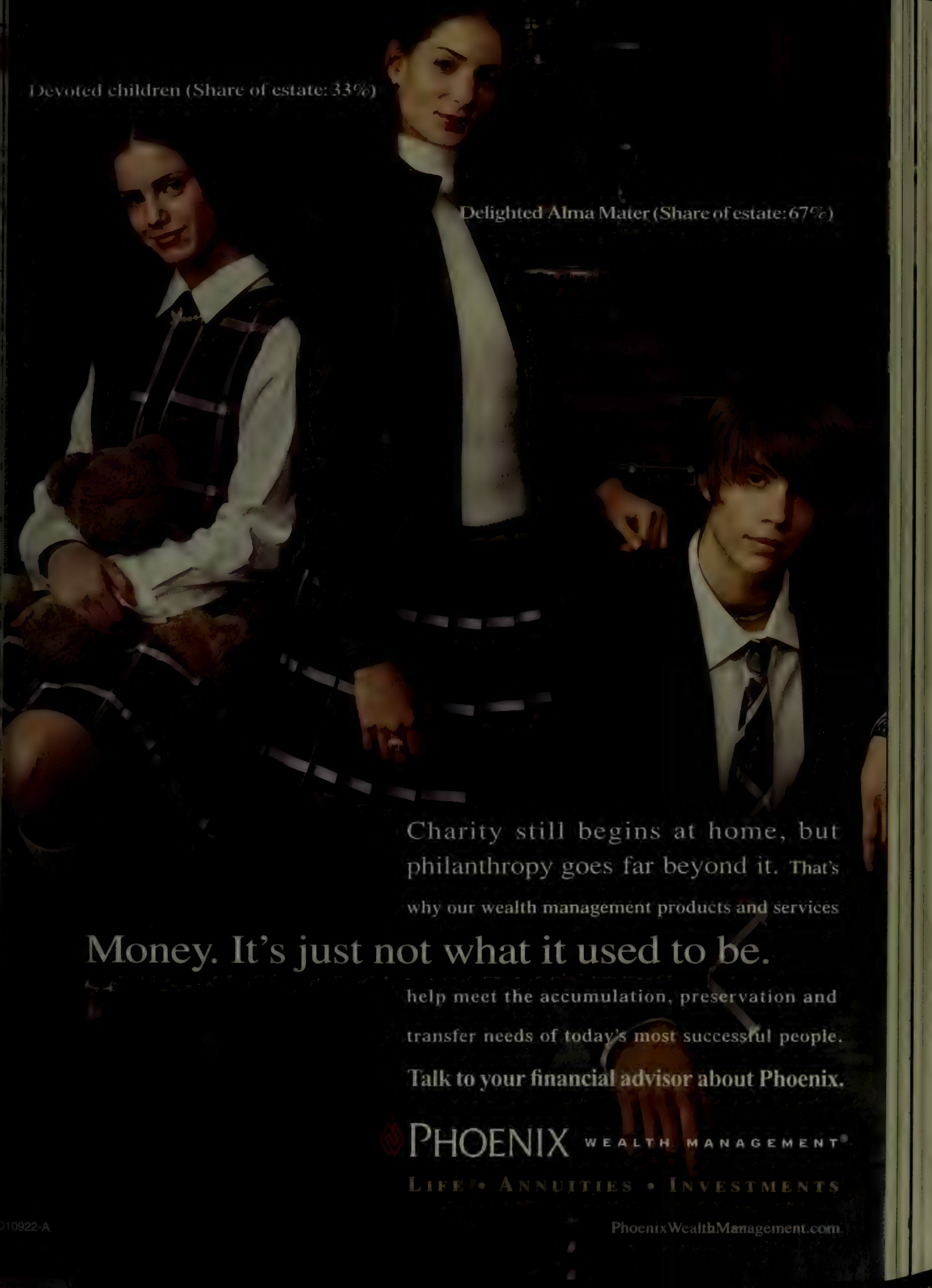
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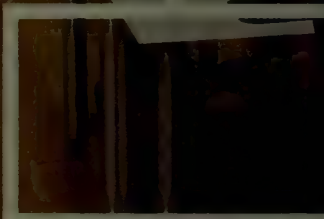
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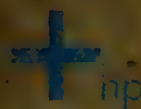
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BY ROBERT KUTTNER

THE GREAT AMERICAN PENSION-FUND ROBBERY



RAIDED:
Pension plans are underfunded by up to \$300 billion. Uncle Sam should force companies to fork over money that was diverted improperly

America's corporate pension system is said to be facing a perfect storm: Equities have taken a big hit (they are still way off their highs), and returns on bonds have plummeted, leaving pension funds with reduced earnings to pay benefits. In addition, corporate downsizing and lengthening life spans have left many companies, particularly in manufacturing, with a rising ratio of retirees to active workers. U.S. Treasury Under Secretary Peter R. Fisher has testified that pensions are underfunded by \$300 billion—far exceeding the resources of the government's Pension Benefit Guarantee Corp.

But if pensions are under water, the cause is less a perfect storm than a leaky boat ravaged by pirates. For more than a decade, corporate sponsors of pension plans have been systematically looting them. The great pension raid is of a piece with the other accounting deceptions of the 1990s, and it had the same motivation—to boost reported earnings and stock prices.

Since the 1980s, many corporations have shifted from traditional defined-benefit plans to defined-contribution plans such as 401(k)s, which cap the company's liability and shift the risk to workers and retirees. But that shift is only the most visible part of the story. As of yearend 2002, some 42 million workers and retirees and \$1.6 trillion dollars were still in traditional pension plans—and these have been raided.

Among the favorite gimmicks for creative theft of pension assets:

- Project an unrealistically high rate of return and claim that the plan is overfunded. Then reduce contributions to the plan and divert the plan's assets to fattening the bottom line. This maneuver allowed corporations to hype reported earnings by 10% to 15% during the 1990s, which in turn contributed to the same stock market bubble that supposedly justified the inflated rate of return. When the bubble burst, pension plans found themselves underfunded.

- Convert from conventional plans to "cash-balance plans." This was invented by Bank of America in 1985 and widely imitated. Terminating a pension plan results in a large tax penalty, so consultants invented a hybrid that quacks like a 401(k) but doesn't trigger the penalty. The Internal Revenue Service went along with the fiction that a cash-balance plan, which reduces payouts, is not really a termination of the plan. The conversion creates imaginary individual accounts that pay a set rate of return. Companies then book their projected future savings as current earnings, thanks to a bizarre determination

by the Financial Accounting Standards Board. On July 31, in response to a lawsuit by IBM won by a federal judge ruled that such conversions constitute illegal age discrimination.

- Redefine employees as independent contractors. In 2001, Allstate Corp., which had long distinguished itself by having an employee force with good benefits, converted some longtime employees to independent contractors, shortchanging their pensions.

- Sell off units that have older employees who then lose their pension benefits. This swells the value of the deal. In 1998, Halliburton Co. acquired Dresser Industries Inc., then sold off its Dresser-Rand unit in 1999. Workers for themselves with pension benefits reduced by an estimated \$25 million. (Dick Cheney got a generous severance and retirement package when he left, however).

- Declare bankruptcy, but set up a special bankruptcy-proof pension plan for top executives as an off-the-books trust. Unlike a "qualified" pension plan, which produces tax benefits for the company, these special executive pension plans are funded in aftertax dollars that would otherwise go to shareholders. Enron Corp. did this. Last April, American Airlines Inc. tried it—relented and had to sacrifice Donald J. Crampton, CEO of American parent AMR, after its union went ballistic. In a bankruptcy, of course, employees can lose some or all benefits.

Once, pension plans were intended to insure loyalty and long service in workers. Now, corporations and their executives seem to care about only one category of worker—top managers, who loot the plans while protecting their own assets. Ordinary long-tenured employees are deemed liabilities.

The remedy for depleted pension funds is much tougher regulation. But the Bush Administration wants to weaken anti-discrimination rules to make it even easier for top executives to have one set of rules for employees and another for themselves. To solve the underfunding problem, the government should be forcing companies to disgorge money that was improperly diverted from plans to corporate bottom lines, thus restoring the plans whole. Instead, the Administration wants to allow companies to use more liberal accounting assumptions about rates of return.

It's fine to have an Administration that protects itself on being pro-business. But don't the tens of millions of employees who loyally serve Corporate America also count as part of business? Should their pensions be protected as well?

Robert Kuttner is co-editor of *The American Prospect* and author of *Everything for Sale*



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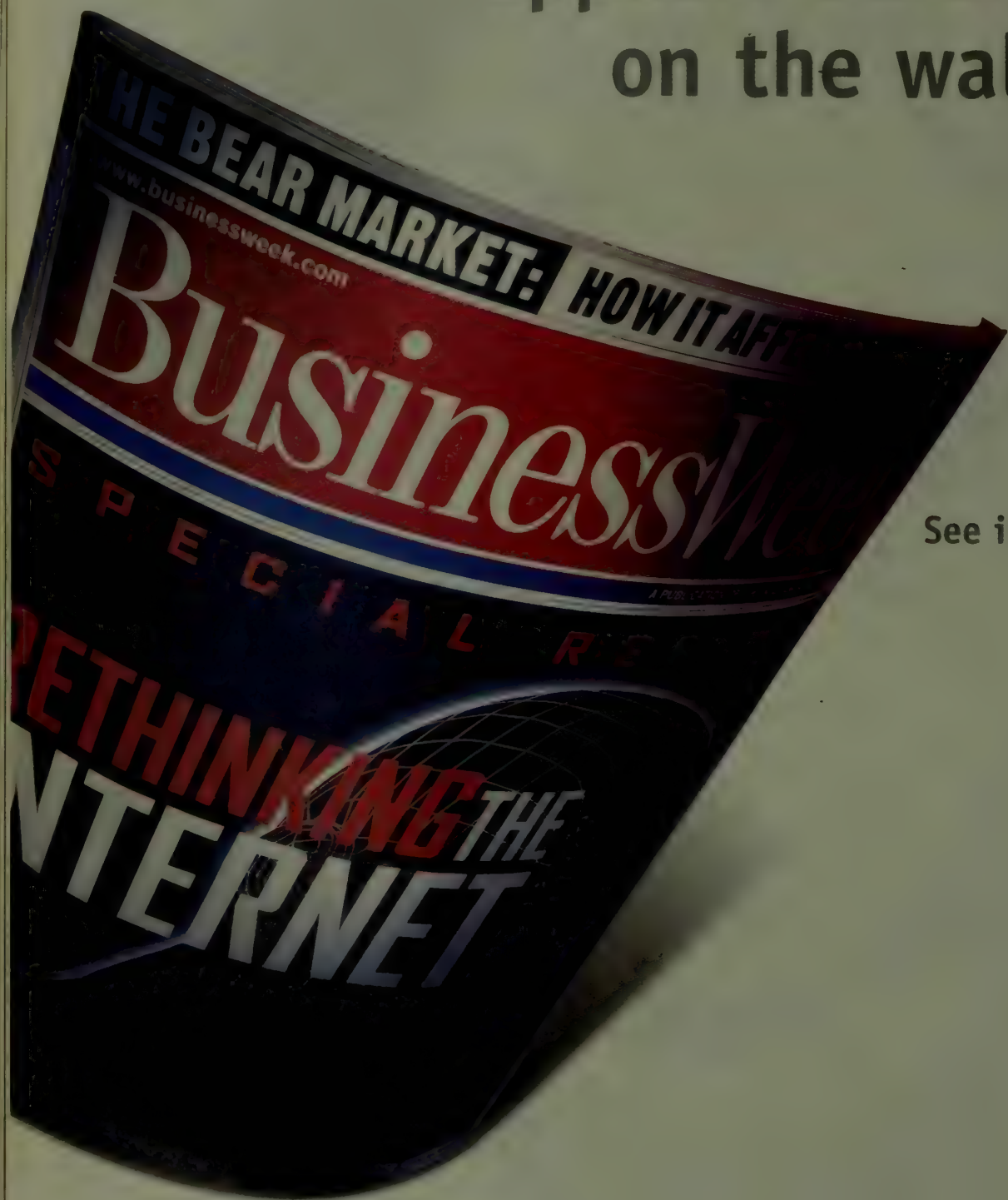
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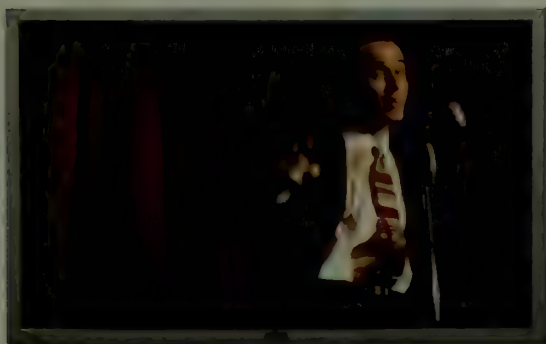


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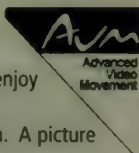


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BOND INVESTORS SHOULD TAKE A CHILL PILL

First it was deflation worries. Now it's inflation fears. Neither is likely

U.S. ECONOMY Many folks in the bond market complain that the Federal Reserve has lost credibility because of the confusing way it communicates its policy. However, judging by the whipsaw pattern of long-term interest rates, that's the pot calling the kettle black. In only three months, bond market players have swung 180 degrees, from worrying about deflation to fears of inflation. Talk about confused.

Given that inflation expectations are such an integral component of bond yields—since a rise in inflation can reduce future returns—the bond market appears to be in a tug-of-war right now over the inflation outlook and what that means for Fed policy. Since mid-April, the yield on 10-year Treasuries has plunged from 4% to a 45-year low of 3.1% in mid-June, only to surge to 4.5% in mid-August, the biggest 11-week jump in 16 years (chart).

Why the yo-yo move? In May and early June, bond folk believed deflation was such an imminent threat that the Fed—which was running out of short-term rate ammunition—would have to take the unusual step of purchasing long-term Treasury securities in an effort to combat it. Bond prices skyrocketed, and yields sank. Now, with the economy showing every sign of a significant acceleration in growth, the bond market fears rapid growth will fuel inflation and cause the Fed to tighten policy. The sell-off sent yields sharply higher.

What the bond market is missing is that its worries about inflation are just as unfounded as its earlier concerns about deflation. With so much unused capacity around the world, particularly in the U.S. labor markets, with the dollar's decline now reversed, and with cheap imports still pouring in, especially from China, the chances of inflation picking up to any significant degree in the coming year are very small.

THE LATEST JUMP in bond yields is especially odd, given that the Fed's official statement after its Aug. 12 policy meeting said, "the Committee believes that policy accommodation can be maintained for a considerable period." That's about as plain as the Fed can be in saying that it has no intentions of raising rates anytime

soon. Indeed, a statement like that, taken in the context of the Fed's own forecast of 3.75% to 4.75% economic growth in 2004, implies that the Fed does not believe that inflation is now, or will be, a threat.

The bond market isn't buying that notion. In fact, in the face of relentlessly good news on the economy, bond investors are now demanding increased protection against inflation. The spread between the yield on 10-year Treasuries and that for Treasury inflation-protected securities, called TIPS, has widened substantially in recent weeks, indicating rising inflation expectations. By Aug. 26, the spread had increased sharply, to 224 basis points (chart).

Signs of a stronger economy continued in the latest week, as August consumer confidence rose, and July durable goods orders picked up, including another gain in capital goods. And housing held its ground in July, with sales of existing homes rising to a record, and demand for new homes slipping only a bit from June's record high. The July and August data suggest that 5% economic growth this quarter is not out of the question.

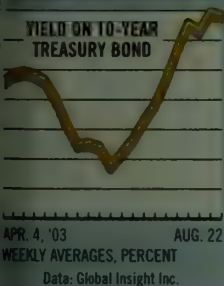
BUT EVEN IF THE ECONOMY picks up steam, inflation is not a worry because of the huge amount of slack created by the recession and the long period of subpar growth since the downturn ended in late 2001. Bear in mind that inflation pressures start to build only when overall demand starts to bump up against the capability of the economy's labor and machines to satisfy it.

But that point is a long way off. The ability of the economy to meet demand has risen. That much is clear from the ongoing trend in productivity growth, which along with additions to the labor force determines just how fast the economy can grow without generating higher inflation. Revised data suggest productivity last quarter grew in the range of 6%, at an annual rate.

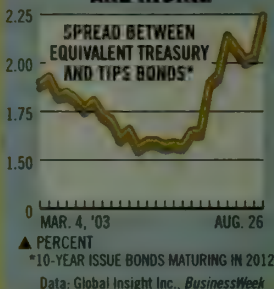
More important, the 10-year growth rate of productivity has accelerated to 2.4%, about a percentage point faster than in the mid-1990s. Adding in the 1% growth rate of the labor force, this upshift means the economy is now capable of sustaining growth in the area of 3.5% over the long haul without lifting inflation.

But over the past three years, the economy has

THE SEE-SAW MOVES IN THE BOND MARKET



INFLATION EXPECTATIONS ARE RISING



Business Outlook

grown at an annual rate of only 1.4%, opening up a sizable gap between the amount of goods and services the economy is actually producing and the amount it is capable of producing. As a result, the economy could grow well above the 3.5% trend for perhaps a year or more without overextending its resources and creating inflation pressures.

NOWHERE IS THIS POINT clearer than in the labor markets, where businesses are relying on productivity to boost output instead of adding more workers. Since the recovery began in the fourth quarter of 2001, the economy has grown at an annual rate of 2.6%, but productivity has shot up 4.3%. That's why payrolls have continued to fall, lifting the unemployment rate to a nine-year high of greater than 6%. Even at 5% economic growth, it will take a long time to reach full employment. Don't forget that the jobless rate had fallen to 3.9% just before the recession began, with nary a sign that inflation was becoming a problem.

Households seem increasingly confident that the economy is improving, but they remain worried about jobs. The consumer confidence index, published by the Conference Board, rose to 81.3 in August, from 77 in July, but an increasing percentage of households said that jobs were still hard to get.

Consumers' assessments of present conditions remained dismal, but their view of the future bright-

ened, as more households expect better business conditions and more jobs within the next six months. Nevertheless, it will take substantial growth in payroll at least 150,000 slots per month, before the unemployment rate can begin a lasting decline, and those kinds of gains aren't in the cards anytime soon.

The final reason not to expect a surge in inflation is weak global conditions. Europe and Japan are each dealing with slack in their production capacity. Plus, the dollar is rising again, especially vs. the euro, as the U.S. outlook improves (chart). The trade-weighted dollar, while down from its early-2000 high, is only back to where it was in the late 1990s, which was some 15% higher than was in the mid-1990s. Because so many countries peg their currency to the dollar, including China, the greenback's power to buy imports is still relatively strong.

Without a doubt, the economy's acceleration makes the probability of inflation in the next year or so greater than the probability of deflation. But both still command very low odds. When the bond market finally begins to understand that, its herky-jerky behavior of the past few months will begin to even out.



AUSTRALIA

HOMING IN ON RUNAWAY HOME PRICES

The Reserve Bank of Australia has added a new twist to monetary policy. Central bankers elsewhere await the results.

The RBA disappointed some investors when it held its policy rate at 4.75% on Aug. 11. Policymakers had been making a case for a rate cut, but in its policy statement, the RBA laid out its reasons for no action. First, the nonfarm economy was in a "strong condition," although domestic demand has slowed.

Second, yearly inflation is running about 2.75%, above the RBA's midpoint target. Lastly, the farm sector is recovering from its drought. Private economists expect the economy will grow by a

solid 3% or so over the next year.

The RBA noted two risks to the outlook: the global economy and the swings in the Aussie dollar.

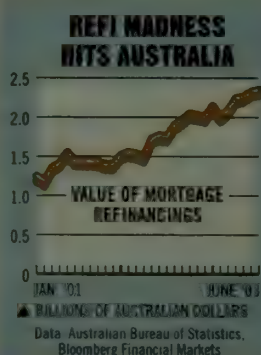
Then the bank ventured into new territory when it warned of "the rapid growth of credit and its flow-through into strongly rising housing prices." Home prices jumped 18% in the year ended in the first quarter, and June home-loan approvals rose 4.1% to a record. By leaving rates unchanged, policymakers hoped to slow the gains in home prices.

The jump has fueled a surge in home-equity loans and refinancings, which have increased household cash flow by about 4% over the past year. That extra money

has largely been spent. The danger is that a drop in home prices will curtail consumer demand and destabilize the economy.

To understand the risks further, the RBA hosted a conference entitled "Asset Prices and Monetary Policy" on Aug. 18-19. Some of the speakers came from U.S. universities and the Bank of England. That's not surprising, since the U.S. and Britain are also dealing with rapid runups in home prices that have fueled consumer spending sprees.

Indeed, officials at the Federal Reserve and the BOE will be watching closely as their Australian counterparts enter a new phase of policymaking. For now, one knows the exact policy response to achieve a soft landing after a frenzied runup in asset prices. The RBA hopes to find out.



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EPIDEMIC

Crippling computer viruses and spam attacks threaten the information economy
Can they be stopped?

David Farber, a professor of computer science at Carnegie Mellon University, was sitting down to lunch with his wife at Taquería Moroleón, a Mexican restaurant in Kennett Square, Pa., on Aug. 21, when his cell phone started vibrating. An e-mail had landed in his cell-phone inbox. Yet as soon as he had cleared the e-mail, the phone vibrated again. And again. And again. He could hardly get a bite in edgewise. Farber was yet another victim of a now-famous computer virus, called SoBig, that turned computers worldwide into drones pumping out millions of e-mails bearing malicious code. It was a digital snowball effect. Farber's conclusion: "We're losing the battle against computer viruses."

Indeed, to those most affected, it seems as if this summer's onslaught of viruses has reached epidemic proportions. Since early August, the world's computer systems have been blitzed by hundreds of viruses—some of them real doozies. On Aug. 11, the Blaster virus and related bugs struck, hammering dozens of corporations, including Air

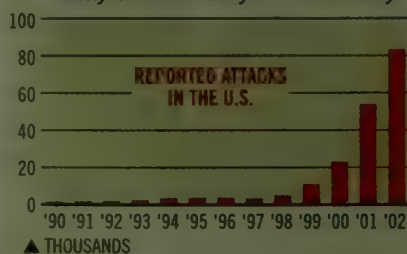
Canada's reservation and airport check-in systems. Ten days later, the SoBig virus took over, causing delays in freight traffic at rail giant CSX Corp. and shutting down more than 3,000 computers belonging to the city of Fort Worth. Worldwide, 15% of large companies and 30% of small companies were affected by SoBig, according to virus software tracker TruSecure Corp. Market researcher Computer Economics Inc. estimates damage will total \$2 billion—one of the costliest viruses ever. All told, damage from viruses may amount to more than \$13 billion this year.

And it could get worse. Six versions of SoBig have been launched since January, each more effective than the last. Security experts are now waiting anxiously for the next one, expected Sept. 11. Because the author of the SoBig virus has turned thousands of computers into virtual slaves standing by to do his bidding as e-mailers, experts wonder what he has in mind. Is he planning on linking up with spammers, spreading their ads around ever more quickly? Or does he have something more nefarious planned—perhaps a new delivery system for an even more malicious virus?

Even as the damage reports pour in, the Summer of SoBig provides a glaring wake-up call to businesses, consumers, and the software industry: It's time to get serious about cyber security. Usually, after each huge virus attack, people promise themselves they'll do a better job of protecting their computers. But they gradually forget about it. "People buy virus programs and firewalls and that's the solution, and they're satisfied. But they're not," says Brian B. Kohn, a Net security analyst at CERT Coordination Center in Pittsburgh, which tracks

VIRUSES EVERYWHERE

Virus attacks are growing rapidly. The 76,404 assaults reported in the first half of 2003 nearly matched last year's entire tally



Data: CERT Coordination Center



viruses for the federal government. "There's always a way malicious code can get in."

And that means the very vitality of the information economy could be at risk. Combine viruses with the scourge of spam, and you have two heavy anchors dragging on an already sluggish economic ship. Indeed, the virus epidemic may undermine tech's productivity boost. A new focus on defense could even discourage corporations from making investments in the latest computers and software. "Every year, we spend more money on security, on monitoring," says June Drewry, chief information officer at Chicago insurance company AON Corp. "That's money you could be investing in other ways."

At the same time, technology experts are warning of the dangers of relying so heavily on just one outfit—Microsoft Corp.—to provide the backbone of the computing and Internet world. With a 95% market share, Microsoft's Windows desktop operating system is a fat, juicy target for the bad guys. The company got so many complaints about SoBig that senior executives, including Windows boss Brian Valentine, were pressed into service manning customer support lines. Some critics even say that Microsoft, as a virtually essential service, has an obligation to ensure that its software is sufficiently hostile to hackers. And while Microsoft has launched a safe-software initiative, tech experts are calling on the company to make more fundamental changes in the way it designs programs. "Microsoft has to write better software," says Paul Saffo, director of think tank Institute for the Future in Menlo Park, Calif. "It's outrageous that a company this profitable does such a lousy job."

All of this raises a troubling question: Will people start to question the effectiveness of the tech gear upon which they've become so dependent? Already, e-mail systems and networks have proved unreliable. Data aren't there at your fingertips when you need them. The e-mail order you're expecting is missing—while your inbox is overloaded with hundreds of junk ads. In the fu-



THE TRAINS DIDN'T RUN ON TIME

Because of the SoBig virus, some routes of rail giant CSX shut down on Aug. 20. A manual backup system came to the rescue, and the company is now scrambling to update its systems. "We are studying how to make them more secure," says spokesman Adam Hollingsworth.

ture, tech systems could become less useful, too. If companies and individuals resort to blocking e-mail from addresses they don't know, it will short-circuit one of the nearly magical attributes of the Web: Its ability to facilitate instant connections between strangers (page 36).

Until now, viruses have been little more than a nuisance. Most of the 80 or so brand-new viruses created each month have little effect, rarely doing more than slowing traffic, clogging e-mail inboxes, and hobbling a smattering of businesses.

But viruses have become far more dangerous of late. Blame that on the ubiquity of the Internet: It has become a veritable virus superhighway. A virus launched one morning can infect computers all over the world by the end of the day. The Slammer virus, which hit in January of this year, spread ultrafast, infecting nearly 100,000 computers in the first 10 minutes alone.

Virus writers are also getting a whole lot smarter—and nastier. Take the Nimda virus, which struck shortly after the Sep-

tember 11, 2001, attacks. Known "blended threat," it was a mix of five different worms, each replicating and attacking computers on different networks. The cure of hacking has changed too. While the previous generation was renegade teenagers, now it's a show off to friends, security experts say that fast-moving, organized international teams of hackers are now posing a larger threat.

What really worries security experts is someone out there, perhaps even terrorists—might be able to wipe out the contents of tens of thousands of computer hard drives or shut down the power

grid. "I expect to see some virus come along that will be seriously disruptive," says Hal R. Varian, dean of the School of Information Management & Systems at the University of California at Berkeley.

Even if such a killer virus never strikes, the combination of viruses and spam e-mail have turned everyday computing into an ordeal for consumers. When people check their e-mail, they are greeted with a seemingly endless stream

HOW THE SoBig VIRUS GOT SO BIG

Data: Trend Micro Inc.



1 Whoever wrote the SoBig program is a skillful hacker.

The virus spread through e-mail and dropped a piece of software called a proxy—into all the machines it infected. That turned them into agents of the virus or others.

vertisements for enlargement, Vi-
cheap mortgages, sexy girls. And
if e-mail is work-
Inpacking a new
iter used to be
g. Now it can be
ht with worry.
ask Linda Beebe,
merican retiree
n Aug. 13 had a
PC delivered to
yrenees vacation
in Mauléon-
usse, France.
Beebe connected
Internet, she im-
ately caught the

r virus, which shut down her com-
It took three full days to get it
ng again. "Now I'm so angry I
even think straight," says Beebe.
course, no one is arguing that
es and spam will stop people from
their computers. "We rely on our
l, on getting on the Internet," says
e. And, for businesses, it's ab-
ly vital. There's no turning back
digital clock. But these twin
ges will turn computing into some-
akin to driving a car: Sometimes
e tooling along the open road. Oth-
es you're stuck—cursing—in city
And unlucky drivers have head-
illions.

e computing world can't count on
enforcement to put virus writers
of commission. Tracking down these
nals is incredibly difficult (page



THE WAKE-UP CALL CAME EARLY

■ Verizon
Communications' new
system for automatically
updating its 200,000
computers with patches
helped it escape this
summer's attacks. "As far
as business impact, it was
a nonevent for us," says
Chief Information Officer
Shaygan Kheradpir.

July 16, it took less
than a month for
virus writers to come
up with Blaster and
a handful of other
viruses that picked
on the flaw. And
since many corpora-
tions and consumers
hadn't gotten around
to loading the patch
yet, they got ham-
mered. It could have
been worse. Mi-
crosoft found the
problem only because
it was notified about
it in June by four
Polish computer sci-

entists, members of the Last Stage of
Delirium Research Group, which identi-
fies software vulnerabilities.

Security experts and corporate tech
purchasers say the glitches exist be-
cause Microsoft and other software com-
panies have placed a high priority on
getting products out quickly and loading
them with features, rather than attend-
ing to security. They're calling on the in-
dustry—and Microsoft in particular—to
make software more secure. Ralph
Szygenda, chief information officer at
General Motors Corp., got fed up when
his computers were hit by the Nimda
virus in late 2001. He called Microsoft
executives. "I told them I'm going to
move away from Windows," Szygenda
recalls. "They started talking about se-
curity all of a sudden."

Last year, amid much fanfare, Mi-

32). Since they're usually not interested
in financial gain, there's no money trail
for sleuths to follow. Virus writers have
proved skillful at covering their tracks.
So far, only 10 have been captured and
convicted—typically because they
bragged about their exploits. And when
it comes to the most complex virus-
es—the ones like Nimda that keep mu-
tating to stay ahead of the cleanup
crews—there are probably a dozen peo-
ple in the world expert enough to fig-
ure them out.

It's a few dozen expert hackers that
law enforcers worry about most. They're
brilliant at exploiting vulnerabilities in
software, and they work furiously once
they spot them. For instance, after Mi-
crosoft identified a major flaw in its lat-
est Windows operating system versions
and posted a patch on its Web site on



After posting
the virus on the
Internet, the
author tricked
to releasing it—
g them to click
ments. The virus
for e-mail
s and then sent
essages to the
s, who couldn't
ent them.



3 Those who got
the e-mails and
clicked on the
attachment got
infected, and in turn sent
out more e-mails to
others. The deluge
clogged up networks and
slowed computing, forcing
people and companies to
spend time and money
fixing their machines.



4 SoBig proxy
software acted
like sleeper cells
in a terror
network. Virus writers
and spammers scanned
the Internet for infected
machines. They posted
lists of these addresses
on Web sites frequented
by spammers and
virus writers.



5 Virus writers
or spammers
could then tap
directly into
those computers and use
them to spread viruses or
send out spam to an ever-
widening universe of
computer users. The end
result: SoBig spread
faster than any of its virus
ancestors.

Microsoft launched its Trustworthy Computing initiative, a campaign it claimed would put security at the core of its software design. As part of the campaign, more than 8,500 Microsoft engineers stopped developing the upcoming Windows Server 2003 and conducted a security analysis of millions of lines of freshly written code. Microsoft ultimately spent \$200 million on beefing up security in Windows Server 2003 alone. "It's a fundamental change in the way we write software," says Mike Nash, vice-president for security business. "If there was some way we could spend more money or throw more people on it, believe me, we'd do it." Yet, embarrassingly, Windows Server 2003, released in April, was one of the operating systems exploited by Blaster. The virus carried a snide message for Microsoft Chairman William H. Gates III: "Billy

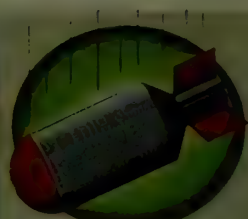
Gates why do you make this possible? Stop making money and fix your software!"

Unfortunately, glitchy software is not so easy to fix. Security experts say the company and the rest of the software industry need to undertake a much more fundamental shift in the way they write programs if they hope to make progress against virus writers. Aviel Rubin, a professor of computer science at Johns Hopkins University, says a lot of the features in Windows are designed to make PCs easy to

THE VIRUS PHYSICIAN'S DESK REFERENCE

Here are the most common types of computer viruses:

Data: Symantec Corp.



BASIC VIRUS
It's a piece of software code designed to infect computers, networks, e-mail or Internet

connections and attach to files on the hard drive, replicating itself. Often present taunting messages, files, or make the computer crash. Example: LoveLetter, in 2000, caused \$8 billion in damage globally.

use and to integrate one program with another—yet it's those very technologies that virus writers exploit. "To make programs secure. Everything comes after that," urges Rubin. "If you don't do this, computers will quickly become unusable."

HOW DO VIRUS HUNTERS TRACK THEIR PREY?

Mikko Hypponen and his band of Finnish computer virus hunters know the odds are stacked against them in the Web's wild frontier. Creators of only 10 of the roughly 200 viruses damaging computers around the world have been caught. Even investigations into high-profile viruses, such as the trio that hit the Internet over the past three weeks, rarely turn up a culprit. "Tracking down a virus is rare," says Vincent Gulletto, vice-president for the anti-virus research lab at software maker Network Associates Inc. "Someone getting caught is even rarer."

So you'll have to pardon Hypponen, the anti-virus research manager at Helsinki-based software company F-Secure Corp., if he got a little excited when he and his team were able to crack the SoBig virus before it finished doing whatever it was meant to do. Thanks to research from F-Secure, a

300-employee company known for cracking tough computer problems, virus experts and government investigators in several countries were able to shut down a network of computers hijacked by the virus on Aug. 22, just minutes before SoBig was to launch what was expected to be the next phase of its attack. "It was a very close call," says Hypponen. "The virus writers will make sure it's not as easy next time."

It was a partial yet rare victory for the good guys. The first line of defense in the exploding war against viruses, only about 500 virus hunters exist worldwide. They face a daunting task: keeping tabs on the more than 10,000 virus creators worldwide. And if being outnumbered wasn't enough, the jobs of such cybersleuths are getting harder as virus writers use ever more sophisticated encryption. "Whoever is doing [SoBig] has been good at covering their tracks," says J. Michael Gibbons, manag-

ing director at consultant Bear Stearns Inc. and a former FBI investigator.

Searching for that culprit is the work of corporate computer experts, academics, and law enforcers. With no governing body telling them what to do, the researchers act like cyber-hunters in a field generating more than \$2 billion a year in software anti-virus sales for companies such as Symantec Corp. and Network Associates. The sleuths range from a wannabe from Moosejaw, Saskatchewan, who went to work for Network Associates fresh out of high school to people like Dr. Peter Tippett, a 50-year-old, both a PhD and an M.D. who is a technology officer for TruSecure, a consultant in Herndon, Va.

Coordinating the counterattacks is the work of federal agencies. Two months after the Blaster hit, the Homeland Security Dept. opened a new unit, the Operational Cyber Security Div., a 60-unit unit drawn from several different computer-security groups. The unit is responsible for sending out computer security alerts, as it did on July 14, the day Blaster hit. "The purpose of what we're doing... is to combine cyber security," says Robert L. Lisoski, a Homeland Security spokesman.

So how do virus hunters go about tracking their elusive prey? A combination of

expert analysis, old-fashioned detective work. First, search for a telltale sign and crack the code of the virus. Then, develop

TRICKS OF THE TRADE

Online detective work and prosecutorial muscle are the key weapons against virus spinners

► Experts monitor virus and hacker Internet chat rooms, where virus writers are known to brag about their exploits

► Virus experts around the world cooperate extensively, comparing research against libraries of more than 60,000 existing viruses

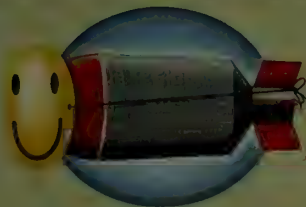
► Just like organized-crime figures, nabbed virus writers are offered reduced sentences in return for ratting on their friends



WORM

A worm can spread itself automatically over the network from one computer to the next. Users

click on e-mail or open a program to get infected. Examples: In 1999, Blaster infected more than 10 million computers. Welchia, another worm, crashed computers and networks, too.



TROJAN HORSE

This is malicious code that masquerades as a benign

program. These bugs don't replicate, but they are used to open "back doors" in computer systems to allow a hacker to take control or steal confidential data. Example: In July, 2000, QAZ, helped hackers view secret source code at Microsoft.



BLENDED THREAT

Viruses that try different ways of infecting and spreading, including basic virus, worm, and

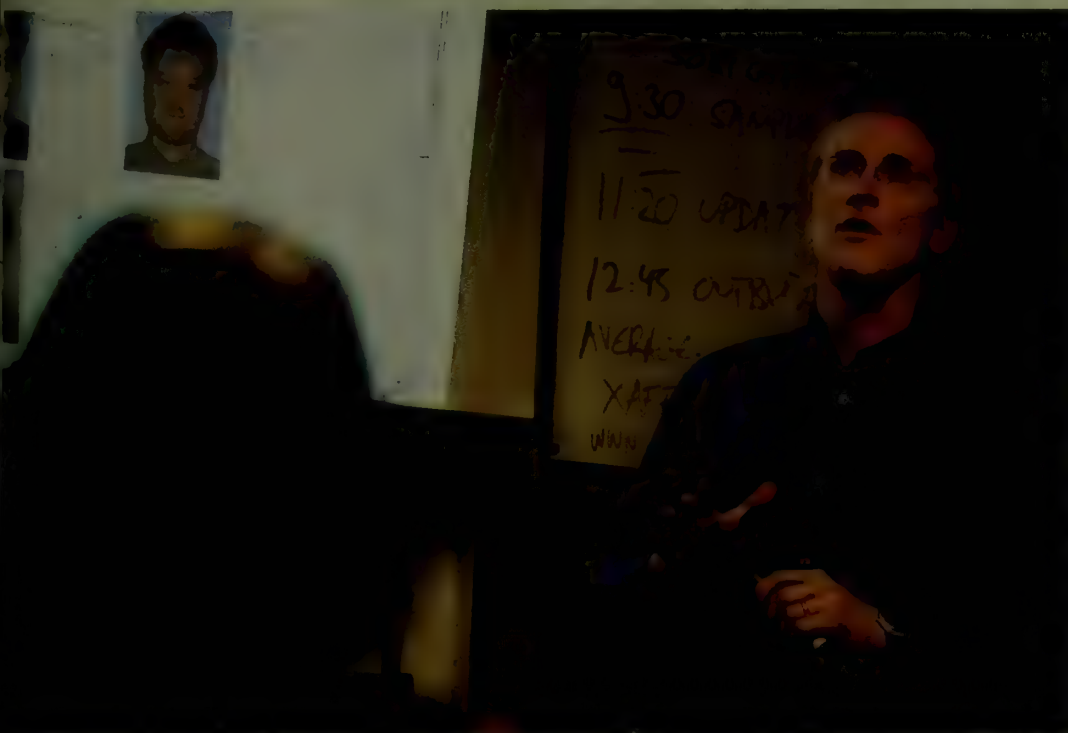
Trojan Horse techniques. Many attempt to use peer-to-peer file-sharing and instant messaging for distribution. Example: SoBig, which hit in mid-August, infected one out of two e-mails traveling on the Internet at its peak.

Some Microsoft critics believe that the only way for the software giant fundamentally to mend its ways is for it to become liable for the damage its customers suffer as a result of viruses. They propose that the software industry adopt minimal standards for software

quality and security. "We need liabilities in software, just like any other consumer product," says Bruce Schneier, the chief technology officer for Counterpane Internet Security Inc., a security software company. "When that happens, this will be fixed. Now, there's no

business incentive to fix the problem."

Others suggest that corporations and consumers switch from Windows to avoid viruses. While Apple's Macintosh computer and the Linux operating system aren't inherently more secure, they're not targets for virus writers the



CYBERSLEUTH

"It was a very close call. The virus writers will make sure it's not as easy next time"

F-SECURE'S HYPONEN, WITH ONSCREEN PHOTOS OF OTHER TEAM MEMBERS

"we were able to figure out what ISP he was using, what kind of browser, his e-mail client, even what bars he went to," says TruSecure's Tippet.

can yield clues about its author. And, researchers scour for clues on Internet message boards frequented by virus writers. For researchers at big companies, getting credit for finding a virus can lend great cachet to their resumes. For small companies such as TruSecure, getting credit for their work can bring in big consulting contracts with clients such as banks. But for the researchers themselves, like virus hunters, the ultimate goal is to catch the virus writers. Sometimes, even when the feds are on the case, they can be stymied by virus writers working abroad. Four years ago, the FBI managed to trace a LoveLetter to a college stu-

dent in Manila. But because the Philippines had no laws making what he did illegal, he was never prosecuted.

That's not to say virus creators can't be caught. In March, 1999, the Melissa virus caused just as much damage as SoBig. But its author was a braggart. Virus hunters at TruSecure combed through huge volumes of messages on Internet chat sites and found a virus writer using the code name "Vicodines" who alluded to writing Melissa. Vicodines also had a habit of saying "hello" to his cats at the end of his messages. Then, a man using the name Doug Winterspoon in another chat room repeatedly mentioned the same cats. By combing through the chat-site traffic,

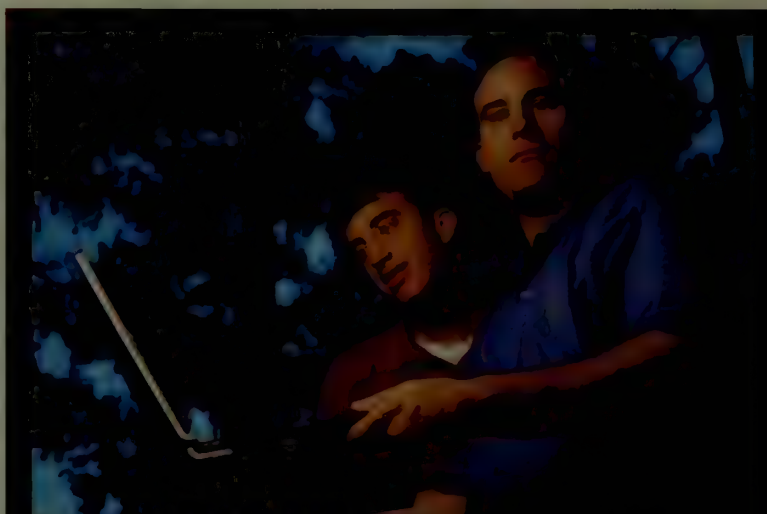
Doug Winterspoon turned out to be David L. Smith. Using information gathered by TruSecure and an ISP account in New Jersey, the FBI tracked Smith down. Melissa, it turns out, was a stripper of whom he was fond. Eight months later, Smith pleaded guilty to causing more than \$80 million in damage to computers and was sentenced to 20 months in prison. Since then, security experts say the savviest virus writers have gone underground, avoiding the chat sites. Virus hunters can only hope the ego of SoBig's author inflates along with his increasingly troublesome virus.

By Jim Kerstetter in San Mateo, Calif., with Paul Magnusson in Washington

way Windows is. Linux has gained traction as a corporate server computer and industry analysts say Linux could become a more attractive alternative on desktop computers if the Windows virus scourge isn't brought under control. The Indian Institute of Technology in Bombay, for instance, is now switching its workstations from Windows to Linux, partly because of security concerns.

For now, much of the burden for combating viruses lies with computer users themselves. Most large corporations already have basic anti-virus software. But security experts maintain that they need to come up with better procedures for frequently updating their computers with the latest security patches to programs and inoculations against new viruses. Verizon Communications Inc. has gotten serious about security in the past couple of years and already has a system for automatically updating its 200,000 computers as soon as patches are available. As a result, it escaped unscathed from this summer's attacks. "As far as business impact, it was a nonevent for us," says Chief Information Officer Shaygan Kheradpir.

Many corporations are sizing up a new generation of security software that approaches threats holistically—with all the defenses plugged into one another. An integrated collection of virus-scanning, firewall, and intrusion-detection software is designed to defeat viruses, no matter how they try to enter the company. A new kind of scanning software checks out not just the labels on packets of information that are zooming



OH DAD, POOR DAD

■ Norcross (Ga.) student Daniel Hamilton, 16, managed to patch his own computer. But his father, newsletter writer Jonathan Hamilton, did not. The result: Dad's home-office computer was out of action for five days. "Live and learn," says Jonathan.

along the networks but also makes sure the data inside are really what the labels say they are. And a security dashboard keeps tabs on everything that's happening on a company's network—looking for evidence that something may be awry. Their purchases are expected to boost total sales of security software by 10%, to \$3.8 billion, this year, while the overall software industry remains flat, according to researcher Gartner Inc.

Small businesses and home users need to be just as vigilant (page 18). Basic anti-virus software now ships on most PCs, and network routers used for Internet access are equipped with firewall software that scans for viruses. But analysts say they fear consumers and small businesses aren't taking advantage of the software they have. It's no wonder. Unlike corporations, these computer users don't have their own info-tech departments. Fortunately, sev-

eral companies offer service with annual fees of \$20 to \$35 that automatically update people when a new virus antidote is ready to be downloaded into their computers.

The key is slaving away downloading new software the moment it's available. Jonathan Hamilton learned that lesson the hard way. The finance newsletter writer in Norcross, Ga., paid no attention to the Windows Update feature in his home office computer. When the Blaster struck, his 16-year-old son, Daniel, dutifully downloaded a patch that blocked the virus. Dad did not. The result: His computer was knocked out of commission for five days, and he barely got his newsletter out on time. "Live and learn," Hamilton says.

But even constant vigilance may not be enough. As with a war on terror, it's not necessarily what you anticipate that can hurt you most. Tomasz Ostwald, of the Last Stage of Delirium Research Group, which spotted the big glitch in Windows, says he's most worried about hackers coming up with new forms of viruses. The worst threat, he says, would be worms that wend their way into companies without being detected, hide, and wait—then perform some act of destruction or thievery. "The most successful attack may be the undetected one," says Ostwald.

That's a chilling thought. In the cyberworld, with brainiac hackers tapping away on their keyboards late into the night, any technical feat is possible. No threat is safely ignored.

By Steve Hamm in New York, Jay Greene in Redmond, Wash., John Edwards and Jim Kerstetter in Mateo, Calif., and bureau reports

HOW TO COMBAT VIRUSES

TECH INDUSTRY Software makers need to make their products less vulnerable. In some cases, this requires line-by-line inspection and retooling of code. They also need to automate systems for bulletproofing programs once installed.

GOVERNMENT The feds already write guidelines to make government PCs more secure, but agencies need to put them into practice faster and plug holes. The government also should require suppliers to build protections into their products, as well as automatic upgrades—or risk losing lucrative contracts.

CORPORATIONS It's not enough to buy security software. Companies should continuously update their defenses and train employees to avoid unwittingly letting viruses in—either by clicking on mysterious e-mail attachments or doing unauthorized Web surfing.

INDIVIDUALS Home PCs should have anti-virus software. But consumers must frequently download protections against new viruses and patches that close vulnerabilities. Some of the latest software includes automatic Internet updates—but users must take time to install them.

July 2002

UBER AUTO

Der Neu Lexus RX 330.
Fasstensietbeltz! p.31



...of the original RX changed the world of luxury utility vehicles forever. Now Lexus has done it again. Introducing the entirely new RX 330. With its Rearview Camera,* Dynamic Laser Cruise Control,* Adaptive Front Lighting System,* Power Rear Door,* Air Suspension,* DVD Rear-Seat Entertainment,* 11-speaker Mark Levinson® Premium Audio System* and Class-Leading Fuel Economy,† the new RX reaches a place most German automobile executives would prefer it didn't, a class all its own. The other place they'd rather not see it, of course, is on the covers of their magazines.

Uber Auto is fictional. Vehicle shown with optional equipment. *Optional. †2004 RX 330 FWD EPA-estimated mpg: Premium 20/24/26 City/Hwy/Comb. 2004 RX 330 FWD EPA-estimated mpg: Premium 20/24/26 City/Hwy/Comb. Always remember to wear seatbelts, secure children in rear seat, obey all traffic laws and drive responsibly. For more information, call 800-USALEXUS or visit us online at www.usalexus.com.

COMMENTARY

By Stephen Baker

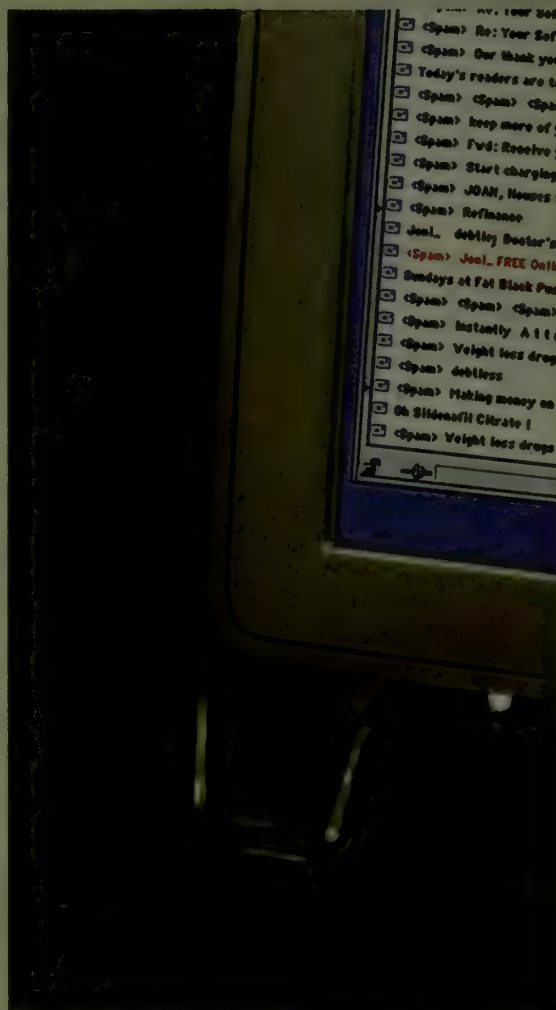
FROM OPEN DOORS
TO GATED COMMUNITIES

No introductions are needed. You already know the Nigerian with the overflowing bank account and the loudmouthed financier offering dirt-cheap mortgages. The guy in the lab coat? His miracle pills and organ enhancements are old news. Thanks to a flood of junk e-mail, or spam, messages from this dubious crowd now account for 50% of all electronic mail. In clogging up the Internet, spam is rapidly turning e-mail into an annoyance and eroding productivity as workers are forced to sift through scores or even hundreds of messages.

And it's getting worse. Sophisticated spammers are unleashing viruses that turn undefended computers into spamming machines. Hackers are also using the same technique for mass-mailings of dangerous viruses and worms. They are "gravitating toward e-mail," says Linda Beck, executive vice-president for operations at Internet service provider EarthLink Inc. As a result, the global e-mail system, one of the most prodigious productivity tools of the Digital Age, is under siege.

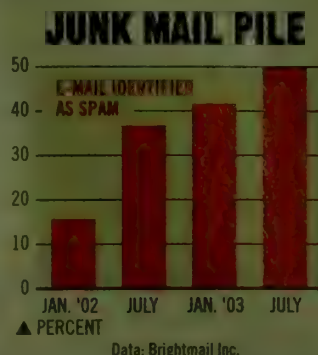
What can be done? Ask anyone in Washington or Silicon Valley, and you'll hear answers. New laws, new filters, you name it. But each one has flaws. None promises lasting relief. Increasingly, it appears that to master spam and reclaim electronic mail as a trusted communications medium, the entire e-mail system must be rethought. This will entail important sacrifices, ones that are bound to rob e-mail of its freedom, breadth, and spontaneity. Drastic measures are bound to run up against fierce resistance. But that may well melt away in the coming year as the spam crisis mounts.

It's bound to intensify as spammers hurdle every obstacle thrown in their way. Consider filters. In early jousts, filters blocked messages advertising, say, Viagra. Spammers responded



with Viagra. Tighter filters establish so-called white lists. These instruct PCs to accept messages only from approved senders. But now, in the age of virus-powered spam, junk mail is likely to come straight from the computers of close friends and colleagues. Brace yourself for Viagra pitches from Mom.

Don't count on much help from Washington. Earlier this year, Congress debated tough measures. This sparked an outcry from legitimate marketers, who rely on the Internet to communicate with customers and suppliers.



For now, the modest bills under deliberation would make it illegal for spammers to hide their return addresses, falsify their identities. Spammers, however, are expected to pay little heed to these or any other laws. And if the estimated 300 spammers who dominate the field feel too much pressure from the Federal Trade Commission, they can always move more operations overseas, a process already under way. Effective global agreements regulating spam years away at best.

This means that companies and individuals alike may well have to refashion e-mail. To stem the tide of spam, look for the wide-open e-mail system today to subdivide into millions of mini, self-contained networks, each serving its own trusted clientele. For starters, companies can be expected to tighten controls on their private networks, known as intranets. If the Internet has been a *Leave It to Beaver* neighborhood with doors unlocked to all, spam will turn into a constellation of gated communities with no-nonsense digital guards at the entrance. "We're entering a new era," Aviel Rubin, technical director of the Information Security Institute at Johns Hopkins University.

GETTING WORSE
The onslaught of spam may erode resistance to tough measures

"More extreme measures are needed. Even these gated communities will require ever-tougher anti-spam technology—and that is bound to slow communications. In an era of virus-generated mail, for example, it will be crucial to distinguish between machine- and human-generated mail. Perhaps the service will have to answer a question to gain access to your inbox.

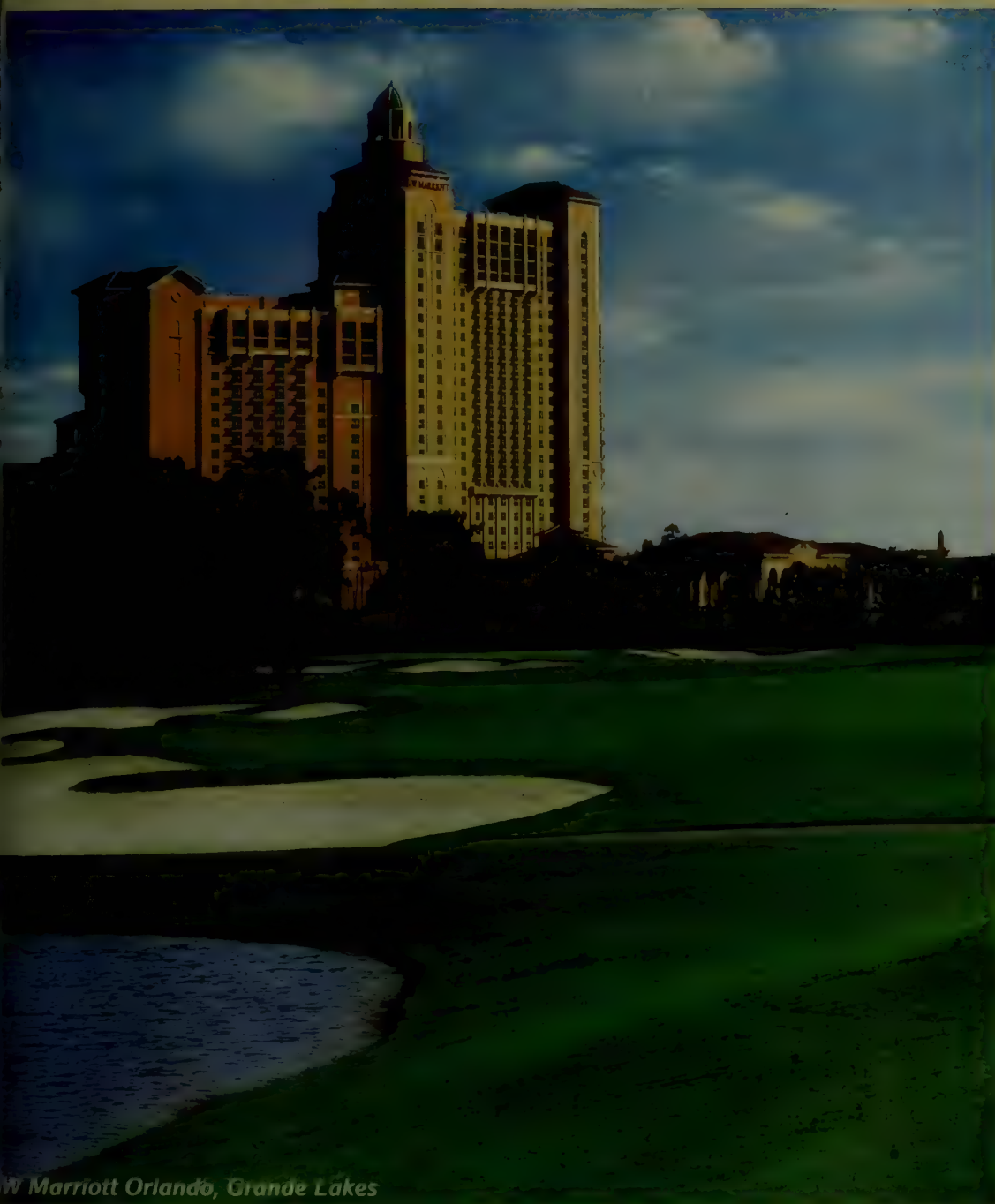
Slow and painful? You bet. And a nightmare for e-merchants whose machines send millions of e-mails. Plenty of inconvenient adjustments are ahead en route to this new world. But with spammers spewing viruses and come-ons by the billions, building a tougher new Internet may be the only choice.

With Lorraine Woolley
in Washington

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COMMENTARY

By Bruce Nussbaum

TECHNOLOGY: JUST MAKE IT SIMPLER

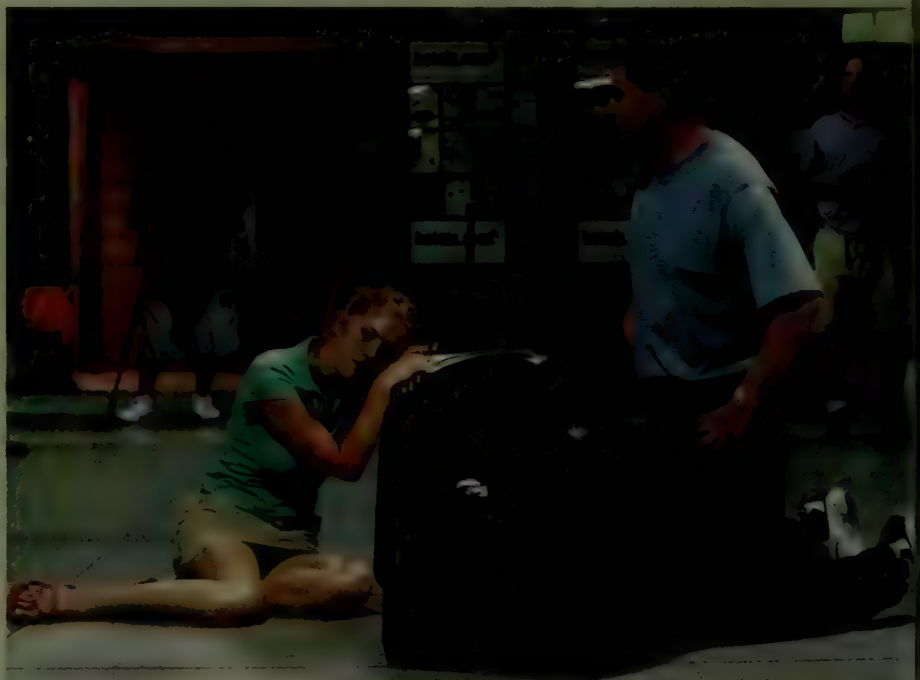
A huge chunk of the electricity grid fails. The Internet clogs up, and PCs crash. The space shuttle falls to the earth. Complex high-tech systems everywhere appear to be failing, and our society feels increasingly threatened. What is going on? Have we built a high-tech society that is doomed to crash and burn again and again? Can we fix it?

Behind these calamities lies a common flaw: The systems are too complex to manage. Each was created with an enormous number of moving parts that threw off an incredible amount of data that had to be observed, analyzed, and managed. But when things went wrong, people had to react very quickly, perhaps too quickly. They had to communicate with many others, perhaps too many. They had to balance conflicting demands in their decision-making—efficiency vs. safety, profit vs. costs, science vs. politics—perhaps too many. Just as the first VCRs had so many features they overwhelmed consumers, our high-tech systems are being designed with far more complexity than we can handle.

We may be making it worse by centralizing and standardizing systems. In an effort to improve efficiencies and cut prices, we are moving toward a single national electricity grid. We already have one standard computer operating system. And while there are many benefits inherent in this kind of integration, it may also be undermining the systems' reliability and security. It is strange for a nation that has thrived on diversity and decentralization to build its economy on the opposite principles. Ironically, our model for the 21st century information society appears to be 19th century industrial society. We are building big centralized systems stuffed with bells and whistles and are inadvertently making America an easier target for economic and political terrorists who can bring down whole swaths of society with one blow.

We are also starving these complex systems of the resources needed to

manage them safely. It is important to build in redundancy and backup for when things go wrong. Yet political decisions and market forces prevent a sufficient cushion from being created. The crash of the shuttle is perhaps the best example. Political pressures in the '90s cut NASA's budgets to the bone,



GOING NOWHERE

Have we created a tech monster doomed to crash and burn again and again?

even as it was shouldering new responsibilities for building an orbiting space station. Under pressure, NASA managers ignored seven pieces of foam that broke off in flights before one destroyed the Columbia. The electric grid failed in part because insufficient investment had been made in it. The decision to keep the grid regulated while the more lucrative power-generation

business was deregulated led to the grid being starved for capital. And computers crashed because Microsoft Corp. put few resources into making software secure and reliable until recently. There were no countervailing market forces forcing it to do so.

In his book *Inviting Disaster: Lessons from the Edge of Technology*, James R. Chiles reminds us that complex systems, by their very nature, are destined to fail at some point. The key is being able to manage the failures early so that they do not grow. If the failure goes unnoticed or is ignored, if it swamps those in charge or links to a wider network and spreads quickly, then it is likely to become a major event, perhaps even a catastrophe.

There is a better way. Design systems that give people adequate time to manage failure. Make them diverse and flexible enough so that parts of a system continue to operate when something goes down. Invest enough resources to have backup that keeps critical functions running when emergencies occur. In effect, provide enough flex in the system to allow human beings the time to manage properly.

Monocultures in nature die because they are too fragile. That's the lesson we should take away from recent events. We don't have a technology problem per se. We need to use markets and the political process to design systems that are within human limits to manage and defend them.

Nussbaum is editorial page editor.

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COMMENTARY

By Mike France

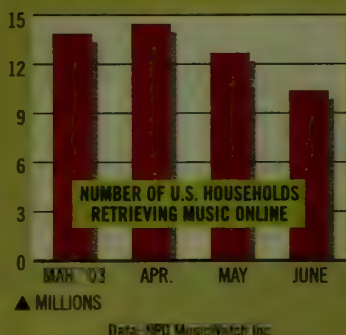
MUSIC PIRATES, YOU'RE SUNK

In early September, the U.S. music industry is planning to break every known rule of corporate public relations by suing hundreds of high school valedictorians, pilots, firefighters, entrepreneurs, and other seemingly upstanding citizens for stealing songs online. The legal confrontation will pit a small group of powerful, technophobic oligopolists against a hip, youthful army of digital sophisticates—who are the very heart of the companies' consumer base. It doesn't take a poll to figure out which side is going to win the battle for hearts and minds.

In the Steven Spielberg version of this conflict, the plucky rebels with the long hair and grandiose rhetoric would ultimately win the war. Until now, that's how the script seemed to be playing out. The Recording Industry Association of America (RIAA), the industry's main lobbying group, has failed to shut down many of the key file-sharing services that facilitate song piracy, such as Kazaa, Morpheus, and Grokster. Some Internet service providers, such as Verizon Communications and SBC Communications Inc., have balked at handing over the names of their customers to RIAA lawyers. And Senator Norm Coleman (R-Minn.) has lashed out at the industry for sending threatening paperwork to "unsuspecting grandparents whose grandchildren have used their personal computers."

But don't be fooled by the industry's rough stretch. The RIAA is methodically overcoming all these nuisances—and its upcoming legal war on digital pirates is shaping up as a massacre. Copyright law is unambiguously hostile to people who swap music files over the Internet. And the penalties are mediocrally harsh—up to \$150,000 per song. That means the average college sophomore with ten weeks of music on his hard drive theoretically faces more than \$1 billion in liability. Oh, and by the way,

DECLINE IN DOWNLOADING



penalties for violating copyright law may not be dischargeable in bankruptcy court. "The remedies are so terrifying that even if you have a good defense, you have to think twice," says Fred von Lohmann, an intellectual-property attorney at the Electronic Frontier Foundation, one of the industry's staunchest critics.

This fear and awe campaign—which the RIAA has publicized in a variety of ways, such as sending instant messages directly to Kazaa and Grokster users informing them that "when you break the law, you risk legal penalties"—already appears to be having an impact. After the number of households downloading music from the Internet climbed to a high of 14.5 million in April, it dwindled to 12.7 million in May and 10.4 million in June, according to mar-

ket researcher NPD Group Inc. This decline is attributable to that vacationing college kids take advantage of their school speed Internet connections—says NPD Vice-President Russ. "The RIAA has clearly raised awareness on this issue," he says.

This is not to say that Universal, Sony, BMG, Warner Music, and others will solve all of their piracy problems in court. New anonymous file-sharing mechanisms may emerge that computer wizards to hide their ties. And overseas downloaders to ignore American lawsuits.

But the fact is that the legal blitz has captured the imagination of one important group of potentially law-abiding citizens who have convinced themselves into believing that music should magically be available for free. This group responds rationally to punishment and reward. Now that the danger of downloading is about to increase, many are likely to turn right into the arms of legitimacy.

Copyright law is clearly hostile to those who swap music files over the Net. And the penalties are stiff—up to \$150,000 per song



services, such as Apple Computer's iTunes and BuyMusic.com. Pressure to buy songs legally will be eased by a continuous stream of lawsuits. Several hundred are scheduled to be filed shortly after Labor Day. Targeted recipients will receive a copy of the lawsuit, a letter explaining the charges, and a number to call if they want to talk about settlement, according to John P. Kenney, the RIAA attorney coordinating the legal attack. "You can expect waves of lawsuits on a regular basis," says Oppenheim. "This is going to be part of our daily routine."

The industry's strategy will be to accuse pirates with the stick of harsh penalties—then offer the relatively mild settlements. In four cases the RIAA brought in against college kids who were accused of downloading miniature Napster-style music. The suits were dropped for settlements ranging from \$12,000 to \$17,500 and writs to cease unlawful file-sharing. Nobody rejecting the offer was that the price of settling would be less if capitulation didn't come. An attorney who defended one student says music lawyers tried to boost the cost of a deal to approximately \$50,000 if he filed an answer.

Even though the RIAA legal campaign is estimated to cost tens of millions of dollars, companies are going to recover a lot of that money in settlement payments. DirectTV Inc. has been running a similar anti-piracy campaign for more than a year in which it has sued more than 10,000 people and sent cease-and-desist letters to 65,000 more. Most settle for between \$3,500 to \$4,500. "We believe we'll earn back close to our attorneys' fees," says Christopher Murphy, DirectTV's assistant general counsel.

That's undoubtedly an encouraging precedent for the folks at RIAA. Although they're likely to be vilified for bullying teens, the PR hit will be a small price to pay for the fear they'll be striking into the hearts of downloaders.

Senior Writer France
reports from the courts from New York.



CRIME

BURNING TO SAVE THE PLANET

A furtive ecoterrorist group is proving tough to bust

The first fire broke out at 2 a.m. at a Mitsubishi dealership in the Los Angeles suburb of Duarte. By 5 a.m., sport-utility vehicles at three nearby dealerships also were in flames. When local authorities arrived, more than 40 SUVs, mostly gas-guzzling Hummer H2s, were charred or damaged. Most also were spray-painted with slogans such as "polluter" and "I love pollution." Greeting the police was a red smiley face plastered on several of the vehicles along with the letters "elf" scrawled in blue.

The Aug. 22 pyrotechnics appear to be a sign of stepped-up efforts by a furtive group called the Earth Liberation Front. A loose amalgam of environmental terrorists, ELF on its Web site says it intends to "inflict economic damage on those profiting from the destruction and exploitation of the natural environment." Experts say that in recent months, ELF members have grown more brazen and accelerated their attacks—and the police are hard-pressed to stop them. "Their tactics are proliferating and the attacks seem to be coming closer together," says University of Florida professor Bron R. Taylor, editor of *Ecological Resistance Movements*. "The size and scale seem to be unprecedented."

ELF has become more ferocious since it emerged in Britain in 1992. At first, the group pulled tamer stunts, such as gluing locks at McDonald's and at gas stations.

But the gloves are coming off. Only weeks before Molotov cocktails hit the L.A.-area car dealers, ELF arsonists torched a five-story apartment complex being built near San Diego.

The group also has claimed responsibility for burning two Vail (Colo.) lodges, in the name of stopping forest development, and torching homes under construction in California, Michigan, and Pennsylvania. By its own tally, ELF has caused \$100 million in property damage nationwide.

Little is known about those involved with ELF. Its Web site offers how-to manuals for setting fires, tips on evading police, and a chronology of fire-bombings. ELF glories in its anonymity. The group did not respond to an e-mailed interview request—and makes

a point of having no spokespeople, eschewing a central organization, and encouraging unaffiliated cells

to follow its attack guidelines.

Given its deliberately liminal nature, ELF is proving tough to bust. "It's such a shadowy, loose-knit collection of cells that it's hard to find them," says Randy Parsons, who heads the FBI's Los Angeles anti-terrorism branch. Why not trace the attackers through their Web site? Because the site provides information but has no direct link to the perpetrators. Only a few ELF-affiliated footsoldiers have ever been tried and convicted.

So what are the authorities doing to stop ELF? The FBI has a national strike team that is coordinating local investigations into environmental terrorism, says agent Parsons. But ELF recruits mostly minors, says Richmond (Va.) FBI agent Lawrence Berry, making it harder to convict them under September 11 anti-terrorism laws. If police manage to catch these folks, they will likely charge them with arson—a lesser offense. Until then, SUV dealers in L.A. are hiring more guards—and bracing for more attacks.

By Ronald Grover in Los Angeles



COMMENTARY

By Amy Borrus and Paula Dwyer

A NEW CHAPERONE FOR FANNIE AND FREDDIE?

Step aside, Terminator. Playing tough guy for a change, the Office of Federal Housing Enterprise Oversight (OFHEO) forced Freddie Mac to ax new CEO Gregory J. Parseghian on Aug. 22. It was a rare display of muscle by the regulator—and probably its last. Freddie's accounting scandal has sparked a fight over reining in the housing financier and its cousin, Fannie Mae—and created a high-stakes battle over how far Congress can go without hurting the housing market.

The one sure casualty is OFHEO, an arm of Housing & Urban Development. Critics want to put Fannie and Freddie on a tighter leash, and even the two government-sponsored enterprises (GSEs), once opposed to a new overseer, have quietly thrown in the towel, Capitol Hill sources say. Congress is likely to create a new regulator in the Treasury Dept., which Secretary John W. Snow is expected to back when he appears before a House panel on Sept. 10.

But critics want to make sure the new regulator has teeth—and that's what Fannie and Freddie are fighting. Their best weapon: Washington's fear that curbing them could hurt liquidity in the mortgage market, boost interest rates, and hasten a housing slowdown. No politician wants the blame for ruining the sector that, thanks to the refinancing mania, has fueled consumer spending—the economy's one bright spot.

Snow may counsel caution. Treasury could get modest new powers, but fundamental change is off the

table for now. The GSEs' rivals, who would like to see them saddled with higher capital standards, stripped of their implicit federal guarantee, or even broken up, will be disappointed again as Fannie CEO Franklin D. Raines musters his lobbying clout to limit reforms.

Congress may order Treasury to approve any new products Fannie

says the lower reserve is sufficient. "While banks engage in a broad array of loans, some of which are riskier than mortgages, [Fannie and Freddie] just have mortgage assets," he says. That logic suits lawmakers, especially Democrats, who fear that a higher standard would reduce the GSEs' overall mortgage financing, making it harder to fulfill their mis-

sion of fostering affordable housing.

Fannie and Freddie are also likely to deflect efforts to limit their investment portfolios. Critics say their combined \$1.6 trillion of investments makes them more like hedge funds with an implicit government safety net. Fannie and Freddie, which get the majority of their profits from such investments, insist the risk is well-managed by hedging. Lawmakers

SHIFT

Clockwise from left: Treasury's Snow may get new powers, and Parseghian is out. Raines, however, still has plenty of clout



and Freddie want to offer, such as mortgage insurance. Detractors, which include such big lenders as Wells Fargo and Citigroup, say the GSEs have moved far afield of their mission to buy loans from lenders and pool them into instruments known as mortgage-backed securities. Fannie and Freddie argue that pre-approval will stymie innovation, which is likely to fall on deaf ears.

Rivals will have a tougher time winning other curbs. They want the GSEs to meet the same capital standards as banks, both to level the playing field and cut risk. By law, Fannie and Freddie must hold in reserve at least 2.5% of their on-balance-sheet assets, vs. 4% banks must hold against their home loans. But OFHEO Director Armando Falcon Jr.

ers, afraid that curbing the GSEs' investment freedom could nudge interest rates higher, will probably agree.

In the end, Fannie and Freddie are likely to get off lightly—unless Freddie Mac's accounting woes worsen. With Freddie expected to restate three years' worth of earnings in late September, fresh revelations could yet spur a Hill crackdown. That also might give credence to arguments, now made sotto voce, that the real problem is that Fannie and Freddie have grown too big and present too much risk. But for now, fear of disrupting the great American mortgage binge has convinced Washington that it's safer just to tinker.

Borrus and Dwyer cover financial policy from Washington.

ONE OUT OF THREE

With Congress afraid of weakening the housing market, Fannie and Freddie will likely face only modest reforms.

CAPITAL Critics want to force both companies to hold the same amount of capital as banks. But at Fannie and Freddie that could cut profits and limit expansion—an argument that is likely to prevail.

RISK Fannie's and Freddie's investments, totaling \$1.6 trillion, leave them vulnerable to big interest rate moves. Yet Congress is unlikely to cap these investments for fear that it could help push up interest rates.

FOCUS In an effort to force Fannie and Freddie to hew to their core mission—making housing affordable to more people—lawmakers want to rein in their ability to issue new products. They'll likely get their way.

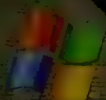
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Windows Server 2003



BUFFETT AT THE PLANT

If he walks away from the Clayton's stock could plu

the deal, analysts warn that Buffett could walk. That may Clayton's stock to collapse shareholders, "this has been high-stakes poker," warns M. A. Perino, a securities law professor at St. John's University.

At issue is Clayton management's handling of Buffett's. From the outset, some institutional investors squawked in protest. Buffett's \$12.50-per-share bid was only a third below where the company's shares traded in mid-July and at the low end of the \$11 to \$15.58 value that bankers placed on Clayton in March. Still, it was a 12.3% premium over what shares traded for when Berkshire

MERGERS

THIS TRAILER DEAL COULD GET TRASHED

Warren Buffett's Clayton Homes buyout may be in jeopardy

When Berkshire Hathaway Inc. struck a \$1.7 billion deal last April to acquire Clayton Homes Inc., it was a classic move for the investment firm and its legendary chief, Warren Buffett. Clayton, a Maryville (Tenn.) maker of manufactured homes, fit Buffett's style of buying boring, brick-and-mortar businesses that appear undervalued. And the deal seemed set for clear sailing. During one easygoing conference call in April, James Clayton, Clayton's folksy chairman, began strumming his guitar while Buffett picked his ukulele over the speakerphone.

Now it appears the tune has changed. Following shareholder approval in July, Clayton management in early August declared the deal done and even stopped trading in its shares. But after dissident shareholders complained that the deal was forced through at a lowball price and with alleged proxy fraud, a Tennessee judge on Aug. 18 put the buyout on hold. With a jury trial now set to take place as early as September, the deal is in danger of falling apart.

The fraud suit, filed by a small Denver pension fund, has raised the stakes for all parties. While Berkshire isn't commenting, Clayton CEO Kevin T. Clayton—James's son—calls the allega-

tions "false, reckless, and offensive." No doubt stakeholders would be quick to settle if Berkshire would boost its \$12.50-a-share offer. But the Nebraska financier warned as recently as mid-July that it "will not raise its price now or in the future." Buffett, whose own actions aren't in question, has little immediate incentive to do so. If the suit fails, he'll get Clayton at the agreed-upon price.

Legal experts say it's unlikely the courts will derail the deal. University of Texas law professor Henry T.C. Hu notes that courts have "historically been reluctant to unscramble" agreed-upon mergers. But if jurors find fraud and attempt to award hefty damages to shareholders or force Clayton to renegotiate

its offer. Clayton management contends that its bid was fair in light of the slump in manufactured housing: Industry prices have plunged 60% since the peak. They also hope that tapping Berkshire's cheap funding sources will give it a leg up over rivals. But some investors still think accepting an offer in April was shortsighted. "We were in the middle of a war. [Buffett's] timing could not have been better," grumbles James Dorr, general counsel for Orbis Investment Management Ltd., which voted its 5.3% stake against the merger.

Dissident shareholders allege that when Clayton management realized they'd lose the shareholder vote so they delayed it by two weeks. Even then, it was a squeaker: Declared starting with the 28% of shares owned by the founding Clayton family, management won over just one-third of the remaining shareholders—giving them 52%, or barely the needed majority.

Even then, investors questioned Clayton's vote. The suit contends that Clayton executives refused to call a vote until they knew they'd win. They refused to give another potential bidder time to mount a rival bid, and may have altered some ballots—allegations Clayton has emphatically denied.

Given Buffett's success as a value investor, could he now face resistance from investors who don't want to sell to him at a depressed price? "The fact that Warren Buffett who wants to buy you should tell you that you should sell, at least not at his price," quips one analyst. If shareholders overturn his deal with Clayton, the Oracle of Omaha may be singing a different tune.

By Dean Foust in Atlanta

UNDERVALUED ASSET?

Clayton Homes stock ceased trading on Aug. 7 after shareholders approved its sale to Berkshire Hathaway for \$12.50 a share



Data: Bloomberg Financial Markets



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In Business This Week

EDITED BY MONICA ROMAN

FOR BROKERS, IT'S COUGH-UP TIME

CHRISTMAS WILL COME EARLY for mutual-fund investors. Many could get millions of dollars in refunds from brokerage firms that failed to pass along promised discounts on sales commissions. In an unusual Aug. 26 industry-wide directive, the NASD, which regulates securities firms, ordered brokers to make refunds, with interest, to investors who were overcharged on their mutual-fund purchases. The crackdown follows NASD surveys that found most brokerage firms failed to cut sales commissions for investors whose holdings qualified them for discounts.

LEWIS BOOTH TAKES THE WHEEL

ON AUG. 27, FORD NAMED Lewis Booth, who had been running the company's Mazda unit, to head its troubled Eu-

ropean unit. Booth will be the fourth boss since 1999 at Ford of Europe, which has been struggling for a decade to rebuild profits and market share. A 54-year-old engineer, Booth replaces Martin Leach, who resigned as president and COO in August. Ford of Europe expected to beef up skimpy profits this year, but competition and currency swings helped drive it into the red in the first half.

WHEN IS A LEASE NOT A PURCHASE?

IF THE U.S. AIR FORCE WERE a company, the Securities & Exchange Commission would be scrutinizing its \$19.6 billion lease of Boeing refueling tankers. Why? To postpone the full cost of the 100-plane deal, the service is calling it an operating lease, not a purchase. But not everyone is convinced. In an Aug. 26 letter, the Congressional Budget Office concludes the transaction is a purchase and says it may be \$2 billion more expensive than an outright purchase. While a purchase would require all the money to be budgeted up front, an operating lease allows annual payments. But despite the CBO's concerns, the Air Force, aided by the deal's political backers (BW—July 7), may still get its way.

MCI: IN HOT WATER IN OKLAHOMA

WORLDCOM'S LEGAL TROUBLES just got worse. On Aug. 27, Oklahoma Attorney General W.A. Drew Edmonson filed criminal securities charges against the telecom company, now known as MCI, and its founder, Bernard Ebbers. It is the first time in the recent corporate crime wave that states have taken the lead in criminally prosecuting a high-profile case. MCI agreed to "fully cooperate" with Okla-

HEADLINER: RICHARD GRASSO

NOW, THAT'S A KILLING

It's quite a payday. After months of speculation about the pay of New York Stock Exchange Chairman Richard Grasso, the numbers were released on Aug. 27—and they are huge. As part of a deal that extends his term as chairman and CEO through May 31, 2007, Grasso, 57, is getting a one-time payment of \$140 million. That's in addition to his \$1.4 million annual paycheck and a "target annual bonus" of \$1 million.

Of the lump sum, \$91.6 million comes from accrued savings and retirement benefits, and \$47.9 million is from prior incen-

tive awards. In a statement, Grasso said that he was pocketing his accumulated compensation and benefits "in order to facilitate personal financial and estate planning."

Word of Grasso's package could turn up the heat on the NYSE chairman, who has been criticized for being removed from investor concerns. A spokesman for the SEC, which is probing stock exchange governance practices, says: "We are looking into the details." So even though the NYSE has given Grasso a vote of confidence, the SEC may not be so supportive.

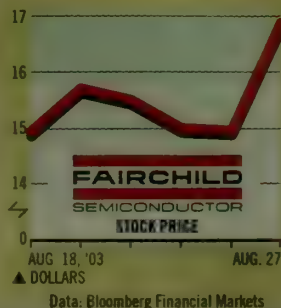
Gary We



CLOSING BELL

HOT CHIPS

With tech on the road to recovery, Wall Street is betting Fairchild Semiconductor will move into the fast lane, thanks to its broad chip portfolio. Fairchild's shares jumped 13.4%, to \$16.97, on Aug. 27 on expectations that higher demand in the computer, automotive, and consumer-electronics sectors will boost revenues and profits.



homa, confirming that it was still on track for a bankruptcy-court confirmation hearing on Sept. 8. Oklahoma's actions came a day after MCI agreed to implement boardroom changes recommended by its bankruptcy-court-appointed monitor. The changes include limiting directors' terms, prohibiting employee stock options, and separating the chairman and CEO jobs. If the changes are adopted, MCI chief Michael Capellas will have to give up one of his titles—and he has said he would.

SIEBEL ASSENTS TO A SETTLEMENT

IT TOOK A LITTLE KICKING and screaming, but Siebel Systems finally agreed to reform its corporate governance to settle a shareholder lawsuit. Brought by the Teachers' Retirement System of Louisiana, the suit accused

Siebel's board of approving excessive pay for founder CEO Thomas Siebel and failing to disclose option grants to directors. To settle the case, Siebel agreed to limit the number of option grants to outside directors and to improve disclosure of option values and pay criteria for directors and executives. It also agreed to several board changes, including adding one new director and expanding the size of compensation and governance committees.

ET CETERA...

- Martha Stewart Living Omnimedia reported an 86% increase in second-quarter profits.
- Marlboro maker Altria Group proved a higher-than-expected 6.3% dividend increase.
- Lockheed Martin agreed to pay \$37.9 million to settle allegations that it overcharged the Air Force on contract

HIDDEN COSTS

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RICHARD S. DUNHAM

HIS CALIFORNIA WILDFIRE S SURE TO SINGE THE WHITE HOUSE

California's truth-is-stranger-than-Hollywood political ruckus has had more plot twists than a cheesy soap opera, and now yesterday's Republican recall dream has led into today's nightmare for the Bush Administration. But tomorrow, as they say, is another day. The White House is still hoping for a victory that replaces embattled Democratic Governor Gray Davis with a Republican leader able to match up to the world's sixth-largest economy and help speed national recovery. In an increasingly Democratic state, however, a win by movie tough guy Arnold Schwarzenegger or some other GOP aspirant may not be in the script.

While President Bush has studiously avoided taking a position on the recall, *Entertainment Tonight's* favorite campaign has galvanized Democratic loyalists across the country. They see it as the latest GOP effort to steal offices Republicans can't win in regular elections. Combined with the redistricting battle in Texas, the Oct. 7 recall has reignited pent-up anger since the Florida recount. J. Pitney Jr., a political scientist at Belmont McKenna College, calls the party Dems "blue hots," for the "blue" ties carried by Al Gore in 2000.

Schwarzenegger's media-magnet candidacy puts the President on the spot because of close ties between the political neophyte and the Bush family. Arnold fired the first President Bush's Commission on Physical Fitness, backed George W. in 2000, and conferred with strategist Karl Rove at the White House as recently as April. Still, Bush must tread carefully. Bushies infuriated California conservatives by siding with moderate Richard Riordan in the ill-fated 2002 gubernatorial primary against hard-right favorite Bill Simon Jr. And though Schwarzenegger has made roads with the Right because of his perceived electability and anti-tax rhetoric, he is a social liberal. Some 35% of con-

servatives backed him in an Aug. 16-21 Los Angeles Times Poll, but many remain loyal to state Senator Tom McClintock.

The irony of Bush's California conundrum is that the White House would have preferred no recall at all. Then the President could have run in a state where the Democratic governor was the most unpopular in history. Now he faces risks whichever way the recall goes. If Davis stages a comeback, it will be seen as a rejection of Republican excesses. But if he is removed, he might be replaced by the state's first-ever Latino governor, Democratic Lieutenant Governor Cruz Bustamante, who leads Arnold 35% to 22% in the Times Poll.



ARNOLD AND PAL IN '90: Family ties

Some Republicans think the only way to rescue the recall is to unite behind Schwarzenegger. Under pressure, Simon has dropped out. And rumors are rife that Rove soon will tighten the screws on McClintock and independent businessman Peter Ueberroth. Bush's campaign flatly denies any involvement, and California Republican Chairman George "Duf" Sundheim thinks pressure tactics are risky. "This is an issue about California to be decided by Californians for California," he says.

Whatever the final outcome, Sundheim sees some positive signs for the Golden State GOP. The party has registered 85,000 new loyalists this year—11% of them ex-Democrats. Ousting Davis would be a sign of GOP muscle. And a pragmatic, reformist party could be poised for gains in 2004 legislative elections. "The soil is being prepared in a way that can be very favorable," Sundheim says.

Perhaps. But the soil in California has been poisoned with partisanship. Bush now trails a generic Democrat 47% to 42% in a hypothetical 2004 match-up, according to an Aug. 10-13 Field Poll. So whether the President's men get involved or not, Bush is unlikely to emerge unsinged by the raging recall.

CAPITAL WRAPUP

POWELL FIGHTS BACK

Chairman Michael K. Powell is trying to put out the firestorm he ignited in June when the Federal Communications Commission relaxed rules restricting the size of media companies. As the Senate prepares to vote in September to gut a new rule enabling TV networks to buy more stations, Powell is trying to quell fears of media consolidation by studying ways to promote local programming. And he is finding allies on the Right. Americans for Tax Reform, the anti-tax, anti-reg-

ulation group led by Grover G. Norquist, is launching an Internet ad campaign and a Web site backing FCC media reforms.

Norquist and others argue that the backlash against Powell will encourage re-regulation—including reimposition of the Fairness Doctrine, which could muzzle conservative talk radio. But there's a split on the Right. Other conservative groups—including the National Rifle Assn. and the Family Research Council—fear that the consolidation push would lead to liberal media censorship of their views.

CRACKING DOWN

► The Securities & Exchange Commission can't lock 'em up, but it can give errant execs the boot. So far in fiscal 2003, it has barred a record 144 execs from ever again serving as officers or directors of public companies. That's more bars in 11 months than the 126 for all of 2002—and a far cry from the 38 in 2000. And under a new policy, those who settle charges without admitting or denying guilt will no longer be allowed to contest SEC allegations in related disciplinary actions.

IS EUROPE ROLLING?

Maybe, but without sweeping reform, recovery won't last

Henri de Castries, chairman and CEO of Paris-based insurance and financial-services giant Axa, is widely credited with keeping his group afloat during Europe's worst economic storms in three decades. Over the past two years, he has batted down Axa's hatches by cutting costs—almost \$225 million in the past 12 months—and jettisoning noncore and underperforming units such as insurance operations in Austria and India. Although its reach is global, Axa still depends on Europe for 55% of its \$70 billion in annual revenue. That exposure was evident when de Castries announced first-half results in mid-August: net income down 75%, to just \$216 million.

Yet de Castries is turning more hopeful about the future, as are many other captains of industry and finance throughout Europe. Like leaves on the sea announcing landfall, signs are increasing that suggest Europe's long recession may be nearing an end (chart). Sure, unemployment continues to rise, and vast areas are still reeling from an unprecedented August heat wave that killed thousands and devastated agriculture. But in Germany, manufacturing is unexpectedly starting to pick up for the first time in months. In France, new-business creation is suddenly zooming. "That's a good sign," says Jean-Paul

Betbeze, chief economist of France's Crédit Lyonnais. "There is a certain amount of optimism now," says de Castries. But he adds an important caveat: "Once more, we'll see structural growth lower than the U.S. and even probably lagging behind Japan."

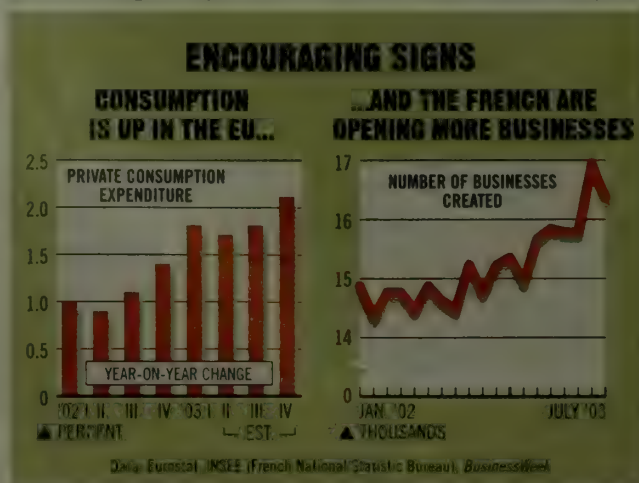
That's the catch. Europe does look set for a cyclical rebound—but it is unlikely to be a strong one. To make any kind of meaningful dent in continent-wide unemployment of 8.1%, Europe needs to grow next year by at least 2.5%. That looks almost unattainable, given low recent rates of investment by European companies. In France, for example, business investment has been declining for nine straight quarters. "The economy has bottomed out, and the downward part of the cycle is over. But there is little real momentum," says Michael Heise, chief economist of German banking and insurance giant Allianz Group. He predicts growth next year in Germany, which accounts for one-third of Europe's total economy, at just 2%.

If there are surprises in store, a growing number of observers think they may well be on the upside this time rather than the down. "The stage is set for the European economy to grow now, and we believe people are being too gloomy," says Nicolas Sobczak, senior European

economist at Goldman Sachs Group Inc.

If he's right, it would be the opposite of the false dawns Europe witnessed over the past couple of years. In early 2002, for example, Germany's top economic-research institutes started signaling sharp rises in business sentiment, indicating a turnaround was imminent. Yet Germany's economy slid back into recession soon after. "[Our] poll is always correct," admits Volker Kleber, economist at Mannheim's Center for European Economic Research. "But we hope it will be right this year."

Part of the new optimism is due to corporate housecleaning. Net corporate debt levels in the European Union are now less than in the early 1990s, and interest rates are at record lows, making the debt much easier to service. Profit margins in France, Germany, and elsewhere are starting to creep up as a result. In recent weeks, companies as diverse as electronics giant Royal Philips Electronics and German chemical giant BASF have reported better-than-expected results despite the terrible economic environment. "This is a real difference [compared] with previous downturn cycles," says Axa's de Castries. "It means companies may come back faster than before, since balance sheets are stronger. The most important change is in the





In what is looking increasingly like a significant break with the postwar tax-and-spend welfare state, some traditionally hesitant politicians are starting to enact pro-growth policies. Although France's 15-month-old center-right government has been backtracking on some promises to reduce the size of the civil service, public-sector payrolls are being shaved back for the first time in five decades. French Prime Minister Jean-Pierre Raffarin recently announced a raft of personal and corporate tax cuts. Silvio Berlusconi, the head of Italy's center-right government, declared in late August that sweeping pension reforms are in the works. Germany, Europe's growth laggard, could now yield the greatest surprise of all. Against a grim backdrop of two straight quarters of recession and rising unemployment, German Chancellor Gerhard Schröder—fresh on the heels of announcing forward billions in tax cuts from 2005 to next year—looks set to carry through much of an economic-reform pro-

If there are surprises in store, many analysts say they will be on the upside

A SHOPPING FRENZY IN PARIS: TAX CUTS MAY BOOST SPENDING

gram he unveiled in March. For the first time, Schröder seems to have overcome critics within his Social Democratic Party. The opposition Christian Democratic Union, meanwhile, looks too fractured to stop the reform process. Still, the opposition's control of Germany's upper house of parliament, where reforms need to be approved, means that some parts of the program could be rejected.

Schröder may be counting on what is beginning to look like a broad change in attitudes about reform. Over the past few months, the German media has been flooded with stories highlighting the perceived failures of Germany's welfare state. "This was unthinkable even a year ago," says John C. Kornblum, former U.S. ambassador to Germany and now head of Lazard & Co.'s German merchant banking operations. "There is an important cultural shift under way."

That may be because the pain has now worked its way through the very heart of Germany Inc. Take Germany's mighty automobile industry, the coun-

try's biggest employer and a traditional bellwether for the rest of the economy. It is now suffering on the back of European car sales, which are declining about 2.6% this year. Although registrations of new cars began rising in June and July, Japanese and Korean manufacturers are the ones benefiting. At the same time, brutal competition in a stagnant market has triggered an alarming squeeze on margins at thousands of suppliers. Their profitability in 2002 declined by as much as 30%, calculates Bernd Kreutzer, partner at the Frankfurt office of A.T. Kearney. "Their financial situation is dramatic," he says.

Tax cuts and continued low interest rates certainly can help energize a sluggish continental economy. But without sustained structural reforms, Europe's overall recovery could prove to be limited and short-lived, economists warn. Over the past few years, Europeans could take heart that, while they may not be as fast-growing as the U.S., they were at least a far cry from recession-and deflation-racked Japan. Will the knowledge that Europe is falling behind Japan—as may well happen next year—be enough to spur action?

By John Rossant in Paris, with David Fairlamb in Frankfurt and bureau reports

THE CASE FOR A REBOUND

LOWER TAXES

\$17.5 billion in German tax cuts moved forward to next year. France and Finland announce personal and corporate tax cuts.

STRONGER DOLLAR AND YEN

European exporters stand to benefit from surge in value of dollar and yen since May.

LOWER RATES

European Central Bank shifted to strongly stimulative rate cuts in late 2002. European rates are at historic lows.

BETTER CORPORATE EARNINGS

European telcos rebound, while groups such as Infineon, Philips, and BASF report upside earnings surprises.

Data: BusinessWeek

IRAQ

THE BATTLE FOR A CELL-PHONE DEAL

Will non-Americans really get a chance in Iraq?

The 400 international telecom execs, equipment vendors, and financiers who crowded into the Grand Hyatt in Amman, Jordan, on July 31 for a briefing on plans to build a new mobile-phone network in Iraq had dollar signs in their eyes. At stake was nothing less than control of one of Iraq's most vital future assets. Since Washington had already awarded billions in uncontested reconstruction contracts to U.S. companies Halliburton Co. and Bechtel Group Inc., the conference attendees had reason to worry that telecom might be the next Americans-only honey pot.

Their concerns were heightened once they saw the terms: No bidder could be more than 5% government-owned. That meant that nearly every mobile operator in the Middle East and Europe was out of contention. Plus, the three winners would be required to post bonds covering the full cost of construction—possibly as high as \$150 million each. Such demanding terms, says telecom-equipment analyst Jason Chapman for researcher Gartner Inc., “would have made the short list very short.”

But a surprising thing happened over the next few weeks. Responding to the outcry from potential bidders, the U.S.-led Coalition Provisional Authority (CPA) twice relaxed its terms. By the time bids were due on Aug. 21, the CPA had lowered the bond requirement to \$30 million and agreed to permit up to 10% government ownership in any bidding consortium. That let state-owned carriers enter the running in conjunction with private investors. More than a half-dozen Middle Eastern telcos have thrown their hats in the ring (table).

The winners will be announced on Sept. 5. The CPA's tender for Iraq's mobile network is a crucial test of its willingness to engage Iraq and the rest of the Mideast in the job of rebuilding the ravaged nation. To date, says Walid Khadduri, editor of the Cyprus-based *Middle East Economic Survey*, “there has been very little reliance on Iraqi institutions.” If the CPA were to award mobile contracts only to U.S. companies, it would shatter any illusion that America intends to spread the wealth.



Such concerns weren't foremost when the mobile contracts were being drawn up. Seeking a lightning-fast rollout, the CPA devised a scheme to carve Iraq into three wireless regions. Each will be served by different carriers. After 12 months, the operators are encouraged to invade other territories in the hopes of fostering competition.

The decision to limit the contracts to two years was perhaps the boldest stroke. After that, a new Iraqi government is expected to organize its own tender—and there's no guarantee September's winners will be picked again. It's an assurance to Iraqis “that we're

not giving it away forever,” says a U.S. Senate Foreign Relations Committee staffer. Thus, most bidders have lined up Iraqi partners. “Having local investors in a winning consortium is as an insurance policy when a subsequent Iraqi government takes over,” says Norman Sandler, director of global strategic issues for Motorola Inc.

On the other hand, the two-year term could make it nearly impossible for companies to recoup their investment. Iraq's infrastructure is so shattered that operators may need to build pricey fiber or microwave backbones to connect cellular towers. The threat of sabotage by rebels necessitates expensive security. And market potential is limited by widespread poverty. Motorola figures on about 500,000 mobile users initially, roughly a \$60 million annual business if customers spend an average of \$100 per month. Such small returns suggest that only the very brave—or if hardy—are plunging into the fray.

If Iraq gets back on its feet, though, the mobile pioneers could end up paying handsomely. Telecom analyst Bo Ostergaard of Forrester Research estimates that mobile penetration in Iraq could rise to 20%, or about 4.6 million users, in three years. That could translate into a \$1 billion annual market. With numbers like that, it's no wonder companies are seeing green. The hope is that some of it stays in Iraq.

By Andy Reinhardt in P

IN THE RUNNING

TURKCELL Turkey's largest mobile carrier is bidding with compatriot Cukurova Investments and a minority player from Iraq

ORASCOM Egyptian giant, part of billionaire Onsi Sawiris' Orascom Group, confirmed on Aug. 26 that it's a bidder

BATELCO Bahrain Telecommunications is bidding with Iraq's Al-Bunna Trading and Singapore's Windmill International

ZAGIL WIRELESS Consortium including Voex, a Michigan company run by an Iraqi-American, plus MCI and Iraq's Ghiath Sukhtian

Data: BusinessWeek

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HONG KONG

A STRONG TAILWIND

Can Beijing quell Hong Kong's dissent by fixing its economy?

Clutching her Ferragamo handbag, Xu Meifeng helps her sister choose a Burberry skirt in Hong Kong's swank Landmark shopping mall. Her husband, Chen Xiaohui, looks on, his wallet at the ready. "The prices are better in Italy," says Chen, a trader from Shanghai who took the family on an Italian shopping trip two years ago. This time, though, the family opted to stay closer to home. "Hong Kong is much more convenient," says Chen.

Things are going to be even more convenient on the Chen family's next Hong Kong shopping spree. Beijing is relaxing restrictions on mainlanders who want to visit Hong Kong. Before the change, Chinese citizens could only travel to the former British colony in tour groups. For the last month, residents of four nearby cities have been able to get individual visas allowing them to come and go on their own. On Sept. 1, that privilege will be extended to residents of Guangzhou, Shanghai, and Beijing.

The measure is certain to be a boon for Hong Kong retailers. So far this year, mainlanders have made up 54% of visitors to Hong Kong, up from 19% a decade ago. Easing restrictions could boost their number by a third, to 10.4 million, next year and spark the flagging Hong Kong economy, Citigroup estimates. Partly as a result of the policy shift, Citigroup has upped its Hong Kong growth forecast for 2004 to 5.8% from 3.8%.

The new rules are part of a broader campaign by mainland authorities to jump-start Hong Kong's economy. Although Beijing once took a hands-off approach to the territory, Chinese officials now want to shore up Hong Kong's beleaguered chief executive, Tung Chee-hwa. He could use some help. Property values have sunk by two-thirds since Hong Kong was handed over to China six years ago. Unemployment is up to 8.7%. And prices have been sliding for nearly five years.



SHOPPING TRIP: Chinese tourists in Hong Kong

Beijing sees Hong Kong's economic woes as a key reason for massive demonstrations in July. That's when a half-million Hong Kongers took to the streets to protest a proposed antisubversion law backed by Tung. Although the measure was the catalyst for the marches, mainland officials figure that if they can get the economy moving again, the opposition to Tung will melt away.

So Beijing hasn't been shy about dishing out the goodies. China has recently signaled that it will approve construction

of a \$2 billion bridge and tunnel linking Hong Kong with Macau on the western edge of the Pearl River Delta. This summer, Chinese officials have hinted that mainlanders soon may be allowed to invest in Hong Kong stocks, while banks in the territory may be allowed to trade the Chinese

yuan—a big step in opening up the country's closed currency. Perhaps Beijing's thoughtful gift is a testament to an agreement allowing Hong Kong companies preferential access to the mainland market. When the measure goes into effect on Jan. 1, it "will be a big step for Hong Kong's service economy what Deng Xiaoping's opening of the Chinese economy in 1978 did for our manufacturers," says Victor Fung, chairman of Hong Kong's giant Li & Fung.

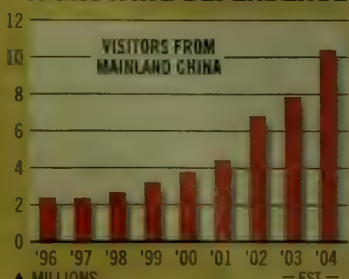
Officials in the neighboring province of Guangdong have been doing their part, too. Guangdong Governor Hu Jintao notes that 80% of Guangdong's exports are shipped through Hong Kong. Two-thirds of the province's foreign investment comes from Hong Kong and Macau, and Hong Kong companies employ some 12 million workers in Guangdong. "Guangdong's success would not have been possible without Hong Kong's help," says Huang

With so much at stake, Huang is eager to strengthen ties. He has become a staunch supporter of the Delta Bridge project. And on August 1, Huang and Tung said they would create eight new committees to deal with cross-border issues. "There's now a realization in both Hong Kong and Guangdong that their economic fates are linked, and there's a willingness to work together," says Michael J. Enright, a Hong Kong University professor.

The payoff from the partnership could be huge. When completed, perhaps as early as 2007, the 18-mile bridge will spur growth on the relatively undeveloped western side of the Delta. Thanks in large part to their proximity to Hong Kong, cities on the east shore have grown at least three times as fast as those in the west. Better access to Hong Kong could bring similar prosperity to western cities such as Zhuhai and Zhongshan—and would boost Hong Kong as well. The city has been through a rough patch. But with the help of their mainland brethren, including shoppers like the Chens, Hong Kong's residents may once again show the world their storied capacity for resilience.

By Mark L. Clifford and Fred Balfour in Hong Kong

A GROWING DEPENDENCE



Data: Hong Kong Tourism Board, Citigroup

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EDITED BY ROSE BRADY

TRADE TALKS: CAN RICH NATIONS KEEP THE POOR ON BOARD?

Can the benefits of free trade and globalization, as well as the pain, be distributed among rich and poor nations in a more equitable way? The 146 members of the World Trade Organization will convene in Cancún, Mexico, on Sept. 4 to ponder that question—and attempt to revive stalled but crucial trade talks known as the Doha Round.

How the U.S., Europe, Japan, and developing countries such as Brazil horse-trade in Cancún will determine whether the Doha negotiations have a chance to be completed on schedule by January, 2005. The talks are the first to acknowledge that 50 years of trade liberalization have left much of the nonindustrialized world behind. But the talks are bogged down because developing nations, which make up three-fourths of the WTO membership, want “special and differential” treatment, while richer countries find it hard to meet demands that mean sacrificing powerful constituencies such as farmers and drugmakers. “There’s been hardly any progress and little goodwill from the rich countries,” complains Martin Kohr, a Malaysian specialist on developing economies.

Now, the rich nations—led by the U.S.—are scrambling to inject momentum into the talks. With the global economy still slumping, a contraction in global trade is the last thing Washington wants. And no one wishes to be blamed for a replay of the 1999 WTO talks in Seattle, which collapsed in a miasma of tear gas and recriminations. Moreover, President Bush’s trade agenda will be deemed a failure if the U.S. allows the Doha talks to unravel. “We want to retain a high level of ambition in Cancún,” says Deputy U.S. Trade Representative Josette Shiner, whose negotiators have logged over a million miles, much of it in travel to Third World capitals, leading up to Cancún.

The biggest challenge will be finding the right formula

for the thorny issue of agricultural trade. The developed world pins its hopes on persuading Europe, Japan, and U.S. to lower tariffs and quotas on imported food and especially, to cut subsidies to their coddled farmers. The farmers of developing countries, which account for 60% of employment and up to 35% of gross domestic product, have been devastated by rich-nation overproduction of commodities such as cotton, wheat, and corn. Because of such trade distortions, poor farmers lose \$24 billion each year, says Washington’s International Food Policy Research Institute.

Brazil, whose commodity exports such as sugar face an

average 15% tariff in the U.S., is leading the effort to pressure richer nations to make sweeping subsidy cuts. U.S. and Europe, with their own history of farming disputes, recently agreed to slash subsidies and tariffs. Details must be worked out, but U.S. and European negotiators hope to hammer over their differences in Cancún and keep talks going with poorer countries.

Poorer nations are also wary of making concessions. India is leading the resistance to a U.S. proposal to cut tariffs on manufactured goods to zero by 2005.

Business wants poorer nations to crack down on piracy of software, entertainment, and medicine. But poorer nations want less, not more, patent protection. In case in point: African and Asian nations without their own drugmakers want to import knockoffs from India and Brazil at a fraction of what they might pay U.S. drugmakers.

Such a concession may be one of the few deals to emerge ahead of schedule from Cancún. The U.S. has acquiesced to looser enforcement of patent rules in Africa to allow the export of cheap medicines. A few more compromises like that will be enough to avoid a Seattle-style calamity.

By Paul Magnusson in Washington



BRAZIL CANE: U.S. tariffs are a hot issue

GLOBAL WRAPUP

PALESTINIAN POWER STRUGGLE

► How long can Palestinian Prime Minister Mahmoud Abbas last? Locked in a power struggle with longtime Palestinian leader Yassir Arafat, Abbas plans to address the Palestinian parliament in early September—and may ask for a vote of confidence. If he does, he’s not sure to win it. Speculation is growing that Abbas may resign, dealing another blow to the U.S.-sponsored “road map for peace,” which the Prime Minister committed to trying to follow in June.

In office just 100 days, Abbas’ political position has taken a turn for the worse since the militant group Hamas carried out a devastating bus bombing in Jerusalem on Aug. 19, killing 21 people. That led to deadly Israeli reprisals against Hamas leader Ismail Abu Shanab and other militants. Hamas declared the temporary cease-fire that Abbas had brokered to be over. Abbas had hoped that the cease-fire would ease pressure on him to “dismantle the terrorist infrastructure,” as the road map requires.

Now, Washington and Jerusalem are

calling for him to act decisively to arrest militants. Abbas lacks the power to do so because Arafat still commands most Palestinian security forces—and refuses to cede control. “Arafat wants a Prime Minister just in name,” says Sattar Kasseem, a political scientist from al-Najah University in Nablus. On Aug. 27, Arafat asked militant groups to renew the cease-fire—another sign he aims to keep calling the shots rather than let Abbas play a more prominent role and take the lead on waging peace.

By Mark Weiss in Jerusalem



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PRODUCTIVITY AND PERFORMANCE

THE GOOD NEWS GETS EVEN BETTER >>



AMR RESEARCH'S MONICA BARRON AND JOHN HAGERTY, AMONG OTHERS, SHARE THEIR EXPERTISE ON MANAGING A COMPANY'S PERFORMANCE AND WORKFORCE.

Companies striving for success tend to focus on the little things, fine-tuning the cogs that make the machine go. They integrate technologies into their enterprise system, measure and streamline business processes, and enhance collaboration and communication throughout the value chain, from purchasing through manufacturing, sales, and service. Yet, in emphasizing these mechanics, executives can overlook a fundamental business reality: the whole is greater than the sum of its parts, even if they're optimized to the max. To reach the next level of success, a company must actively manage its enterprise productivity and performance, not just measure and refine them.

One emerging approach to this challenge, called Enterprise Performance Management (EPM), combines software applications and business processes with performance measurement and management strategies. In doing so, EPM creates an iterative, continuous process that mixes the best

of the command-and-control management philosophy with the nimbleness of sense-and-respond activities. The objective: rapid readjustment to changing business conditions, improved decision making, and better performance.

EPM is part philosophy and part technology. "It's where strategy and planning meet execution and planning," says John Hagerty, vice president of research at Boston-based researcher and consultant AMR Research Inc. "EPM combines strategic goal setting and alignment with planning, forecasting, and modeling capabilities. It uses powerful analytics to drive smarter operational plans and supports the agility needed to respond to changes and opportunities as they occur. The ultimate goal of EPM is to help companies pilot the business in the desired direction."

Unlike traditional measures, though, EPM reaches beyond simple financial assessments. "EPM is about total company management," Hagerty adds. "It takes into account all aspects

PRODUCTIVITY AND PERFORMANCE

of what a company does and will do, from people to processes to operational activities to financials. It's across the board. And it's not a one-time deal. Experienced companies characterize EPM as an implementation followed by endless tinkering."

TOP TO BOTTOM

A fully developed EPM strategy includes all enterprise operational concerns, such as supply chain, customer management, and production issues. It evaluates the performance of the organization not just by such conventional measurements as gross sales and profit margins, but also by any criterion defined as critical to the company's success – such as customer churn, manufacturing quality, or inventory turn rates. In addition, EPM assesses the performance of the enterprise from entities as large as business units down to the contributions of individual employees. By aligning the activities of individuals with corporate goals and providing frequent feedback to employees on how well they are doing, EPM seeks to get the most from the workforce.

Corporations are clearly beginning to recognize the importance of EPM: some 40% of companies recently surveyed by AMR Research reported that EPM is one of their top initiatives for

between when events occur and when management understands what's happening. Traditional performance results are reported weekly or at the close of a month, limiting managers to stale information. EPM creates an environment in which business operations are monitored in real time. Static reports are replaced by interactive software presentations such as dashboards and scorecards, which deliver relevant information to the appropriate users as it happens.

Further, EPM can be used to integrate disparate activities, merging such activities as planning and reporting cycles. With the new information, companies can view intelligence about the business in the context of a forward-looking plan that drives the business in a desired direction, instead of a historical report that only describes past activities. Says Hagerty: "EPM allows executives to shape the company so that it performs in a preferred way, rather than just letting performance happen without direction."

For example, weight-management services provider Jenny Craig Inc., in Carlsbad, Calif., recently began a performance management initiative that helps the company track, understand, and manage client progress and loyalty and

TO-DO LIST FOR ESTABLISHING A PERFORMANCE MANAGEMENT BASELINE >>

REQUIREMENT:	RESPONSIBILITY:
1. Identify company strategy and key drivers	C-level executives
2. Agree on what metrics will be used to measure these drivers	C-level executives and IT, line-of-business chiefs
3. Prepare the data	In-house business and IT resources
4. Establish common business definitions	C-level executives, LOB chiefs

Source: AMR Research, 2003

2003. "There is an increased drive by senior management and executives to create alignment and accountability at all levels of the organization, which supports optimal performance," explains Hagerty. "To do this, companies must ensure that each employee understands the corporate goals and what his or her role is in achieving those goals. That's what EPM provides."

Moreover, the business community is demanding the kind of accountability and visibility that only a properly executed EPM initiative can deliver. The need for meticulous external reporting – whether for Sarbanes-Oxley Act compliance, government regulators, or market watches – increases the need for performance tracking and management. Says Hagerty: "I think performance management is in the right place at the right time."

REAL TIME = REAL RESULTS

How can a solid EPM strategy help companies become more competitive? First, such initiatives reduce the lag time

the success of direct-marketing campaigns. Using software from Business Objects SA, a French-founded company with US headquarters in San Jose, Calif., Jenny Craig now provides more than 100 field managers with access to real-time information. "We frequently offer promotions and coupons in our direct-mail campaigns," says CIO Sara Braziller. "The system allows our operations group to work with marketing to use point-of-sale data to analyze the coupons redeemed by region. We realized we didn't have to be quite so generous in some areas – that there were markets where we could scale back these promotions and save money, without losing any sales."

The good news is that most companies embarking on an EPM initiative have much of the technology foundation already in place. An optimal EPM solution includes a technical framework that supports data marts or warehouses, reporting systems, and business intelligence; planning systems that help the organization look forward; and visualization products like dashboards and scorecards that



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PRODUCTIVITY AND PERFORMANCE

provide users with Web-based access to information they can view, query, and investigate. The trick is taking these discrete systems and combining them in a holistic fashion that supports collaboration and the exchange of information.

Elements that aren't already available can be implemented incrementally. "You don't have to adopt an EPM strategy full-bore," says Hagerty. "It's better for companies to pinpoint their biggest source of pain and adopt a solution that addresses that. Then grow the EPM solution from there."

YOUR MOST VALUABLE ASSET

Because approximately 60% of operating costs are personnel-related, many executives are choosing to focus first on the aspect of EPM that concerns so-called human capital management (HCM). "Companies are looking for better ways to link employee activities to corporate strategies," explains Monica Barron, research director for HCM at AMR Research. "There is a long-standing chasm between the two. Often employees don't know what the organization is trying to do or how their efforts can help achieve those goals."

In addition, reduced workforces and increased pressure to achieve can expose an unpleasant reality: executives often have little knowledge about the capabilities and skill sets available in their employees. "Most companies have no mechanism in place to ensure that people are doing the right thing or have the right information in the right place at the right time," explains Debbie Schmidt, global vice president for HCM at SAP AG, in Walldorf, Germany. "And beyond sales and production, they have very few objective measures to even assess how well employees are performing."

In recognition of this need, companies are increasing spending on their HCM-related applications. According to AMR Research,

89% of companies will initiate an HCM software project in 2003. Most will focus on the dual challenge of reducing administrative costs while enhancing programs designed to attract and retain top employees. Although budgets for HCM projects are expected to rise only 4% this year, AMR Research projects that such areas as workforce acquisition and optimization and incentive management will be hot.

Yet Barron warns that technology solutions cannot replace either a culture that values employee contributions or in-place processes that are supported by executive management. "Technology alone won't do it all," she says. "Companies definitely need to have the processes in place. But solutions can enable companies to do a better job with their HCM-related performance management initiatives."

EMBRACING CHANGE

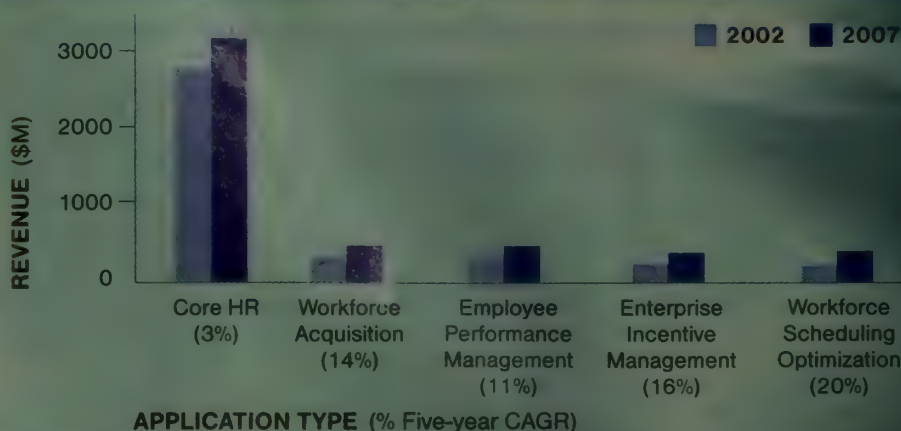
HCM software systems are especially adept at helping companies manage change, for both employees and managers. Employees are expected to work more productively and efficiently now than ever before, shaping their own career paths. Companies that once valued compliant, conforming workers now need innovative, out-of-the-box thinkers.

Manager roles are also changing. Leaders must align employees and activities, decide to invest corporate resources in particular individuals, assign workers to support customers, create teams, set goals and objectives, and measure and follow through on all activities. "The primary customer of most HR organizations is no longer the employee, it's the manager," says SAP's Schmidt. "Helping managers to meet their goals is a key priority across the board."

HCM tools such as dashboards and scorecards facilitate the management of change throughout the organization.

Dashboards automatically deliver information to individual employees in the formats they need, from simple highlights to deep analysis. By pushing critical data directly to the desktop, dashboards enable employees to take action quickly. This rapid access can help managers and employees head off problems before they escalate, explains Jason Averbook, director of HCM global marketing for PeopleSoft Inc. in Pleasanton, Calif. "Dashboards can also act as a control center for HR organizations, providing visibility in real-time on a host of important workforce issues."

**HCM TOTAL REVENUE FORECAST
BY APPLICATION SEGMENT, 2002-2007 >>**



Source: AMR Research, 2003

COMPENSATION HEADACHES WEIGHING YOU DOWN?

< unable to gain competitive advantage

< can't reward for performance

< inaccurate reports >

< overwhelmed with complaints

< gap between pay and market

< in mindshare
market share >

< inflexible compensation systems

< error-prone payments

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PRODUCTIVITY AND PERFORMANCE

Scorecards can help the entire workforce understand how its performance relates to company goals, in between formal evaluations. "Scorecards are a familiar delivery mechanism that people feel comfortable with," notes Averbook. "Employees and managers can use them to explore certain aspects of the information in real time, asking more questions so they understand what they need to do their jobs better."

All these tools are most effective when delivered through Web-based portals or corporate intranets. Electronic availability enables employees to access current information at their convenience, usually with one click. With drill-down capabilities, they can pose queries and dig deeper for causal relationships. The objective is to facilitate the kind of decision making that will support the company's overall business goals.

Another critical tool for HCM performance management is workforce analytics or workforce information management, which helps executives correlate cause and effect and manage the workforce throughout the entire hire-to-retire life cycle. With links to operational systems and traditional human resources applications, the insight these systems can produce is powerful. Says Patrick Morrissey, director of marketing for Business Objects: "Properly used, these analytics enable executives to gain real insight into the costs and value of their human capital, and to show the business results as they cascade throughout the organization."

SHOW THEM THE MONEY

Although past performance management efforts concentrated on sales reps and other workers whose efforts can be easily quantified, today's EPM initiatives can extend to all employees of the company. Goals for these employees can be set qualitatively, using criteria-based objectives that each employee understands and can work toward. In fact, some businesses even include corporate stakeholders outside the organization – such as business partners and distributors – in the performance management approach.

The most effective way of shaping business behavior is to reward people for doing what management wants, aligning compensation with the achievement of corporate goals. "If you're not linking performance to pay, you're not truly doing performance management," says Mark A. Stiffler, president and CEO of Synegy Inc., in Conshohocken, Penna. "The reward is key."

Employing enterprise incentive management (EIM) technology, businesses can encourage behaviors that support corporate goals, such as selling high-margin products, cross-selling or up-selling to profitable clients, or enticing independent distributors to sell the company's products.

EIM solutions support complex variable compensation plans, and EIM modeling capabilities enable companies to project the cost and impact of proposed changes to compensation.

Amersham Biosciences, a (Piscataway, NJ) company focused on disease research, is using an outsourced EIM package from Synegy to improve the performance of 165 sales reps, managers, and other employees. Weekly sales reports are now available through a Web portal. The system enhanced payment accuracy, which boosted the confidence of the sales reps in the compensation system and reduced the number of questions to the company's business operations department enough to cut head count. Says Dan Eldridge, manager of the company's business operations: "I don't lose sleep over the quarterly incentive compensation calculation any more."

PRIZES WORK, TOO

Most EIM applications replace either spreadsheet or manual approaches, which can be inflexible and error-prone and can consume tremendous administrative resources. The technology offers both tactical and strategic benefits, says Chris Cabrera, vice president of worldwide sales and business development for Callidus Software Inc., in San Jose, Calif. "Paying people more accurately – the right amount to the right person, on time, every time – can generate savings of from 7% to 10% of a company's total compensation budget in reduced error rates," he explains. "But driving more effective business behavior and making more intelligent decisions is a matter of true competitive advantage – one that can add substantially to company revenue and overall productivity."

One Callidus Software customer, New York-based Lexis-Nexis Group, a division of Reed Elsevier Inc., chose an EIM package to create a single repository of commission information for its global sales force. The company, which delivers legal, business, government, and tax information worldwide through a portfolio of companies, now publishes its 1,200 monthly commission statements through a secure Web site. "We've transformed our group into a payroll-style service, with a credible audit trail, highly accurate calculations, and tremendous service to our customers, the sales reps," says Michael Weber, senior director of finance. "Our productivity has gone up, and the time needed for dispute resolution has gone down. We can shift our compensation plan as conditions change, and our sales management team is thrilled with the flexibility it has to create compensation plans that drive incremental revenue."

A complementary pay-for-performance technology is enterprise incentive and recognition (EIR), which adds



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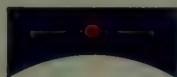
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PRODUCTIVITY AND PERFORMANCE

prizes and awards to basic and variable compensation. EIR is often used to provide high-profile, prestigious awards that appeal to employee pride. EIR applications not only automate the administration of prizes and awards, but also help companies measure their results so they can be fine-tuned for even greater effectiveness in future campaigns.

According to Michelle M. Smith, vice president of strategic sales for San Francisco-based Bravanta Inc., companies can use EIR technology to change course more easily than changing base salary. "If you add a contest or an incentive to address an immediate business need," she says, "it extends your toolbox of performance management options."

ROI IS KING

Cost-justifying an EPM initiative can be challenging in an economic climate that often demands a return on investment on new projects within the first year. In the best of cases, quantifying the value of EPM is difficult because the true worth of analysis – exposing previously unrecognized information to decision makers – is tough to calculate. According to AMR Research analyst Dana Stiffler: "It's more about shining a light into corners to see what's there, and more importantly, what you choose to do about it." In a survey of two dozen North American and European companies who have implemented an EPM strategy, AMR Research found that the minimum initial project cost was \$500,000, including hardware, software, and services. Many companies did not begin to realize benefits until a year or more into the project, and some of those benefits were soft, not hard.

Yet Stiffler reports that these EPM initiatives are working: "In marked contrast with the grumbling we often hear about ERP implementations, not a single executive we spoke with regretted embarking on these projects. While returns are not instantaneous, they are undeniable."

For example, Dow Corning Corp., the \$2.6 billion (Midland, MI) manufacturer of silicone products for commercial applications, expects to generate \$53.7 million over 10 years from its recent SAP HCM implementation – for an ROI of 163% in less than four years. The solution transformed the decentralized Dow Corning HR organization into a tightly integrated unit, which created improvements in global employee management. Now Dow Corning can more easily understand the demographics and capabilities of the workforce and make better decisions about how to structure the organization. "The global single-instance database has been the best thing that has ever happened to Dow Corning's global strategy," says Jeff Scherting, e-business and finance process specialist at the company.

THE CHIEF SETS THE COURSE

Experts warn that EPM cannot be driven by IT or departmental managers; it must be sponsored and supported at the executive level. "We've seen many projects where someone in mid-management or IT has a dashboard tool looking for a home," says Morrissey of Business Objects. "But if the project isn't sponsored by a senior executive, it's going nowhere in a hurry."

As with any key corporate initiative, executives need to set their own performance management goals, letting vendors help – but not dictate – direction. Performance management may be one model, but it is not the only picture, says Hagerty of AMR Research. "Companies need to judge vendor messages against their own business goals. Executives can take control of the process by creating an architectural blueprint on the front end. Not only will a blueprint make it easier to adopt EPM in affordable increments, Hagerty points out, "It's the best path to achieving real performance management success."

AMR RESEARCH >>

AMR Research is a strategic advisory firm that provides critical analysis and actionable advice to business and technology executives to help them manage resources, assess and mitigate risk, and increase business value. The company's research initiatives are based on The Performance-Driven Enterprise, a practical approach to understanding how business strategy drives technology adoption. AMR Research, founded in 1986, is headquartered in Boston, MA.

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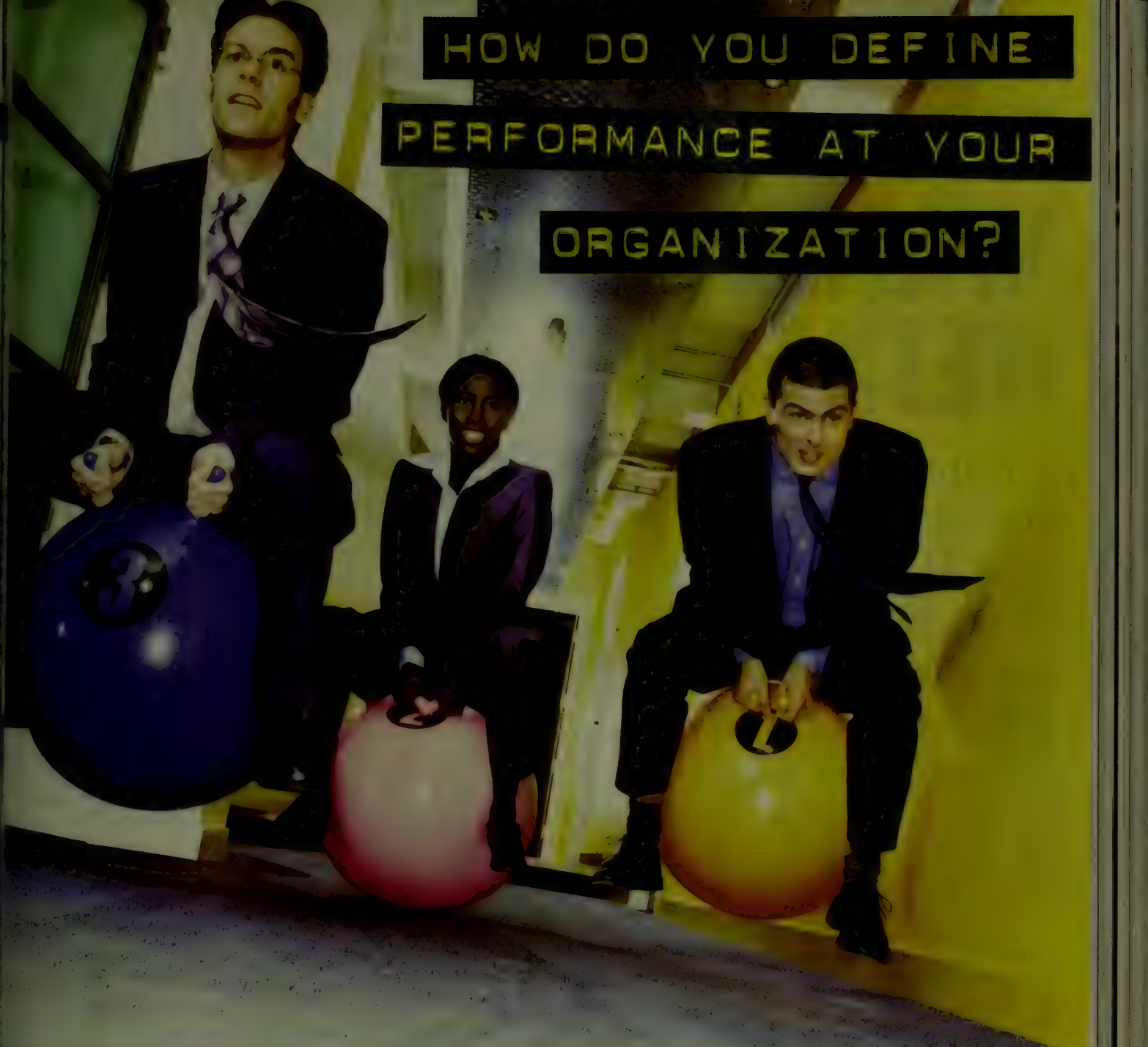
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WAKING UP HEINEKEN

Earnings are flat. Beer drinking is down. Can it get growth flowing?

History stares Heineken boss Anthony Ruys in the face every morning when he shows up for work. The Dutch brewer's chief executive sits in a dark-paneled office surrounded by stern portraits of three generations of Heineken ancestors. The Amsterdam headquarters extends from the building that once served as the family manse. And if Ruys were ever to forget that he was the guardian of a corporate legacy that traces its roots back more than 400 years, he would have to reckon with its main shareholder: Charlene de Carvalho-Heineken, a descendant of the company's founder.

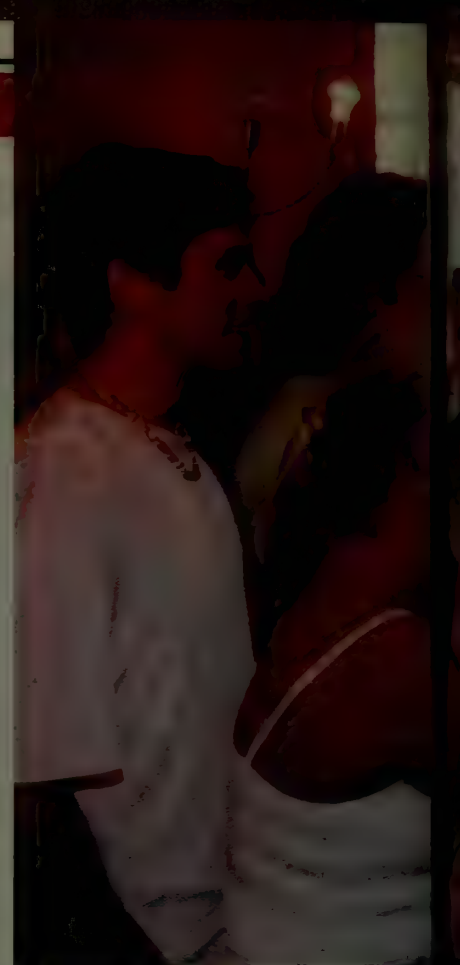
"There's a long tradition," says Ruys with typical Dutch understatement.

Starched white collars are no longer the order of the day at 21 Tweede Weteringplantsoen, but Heineken headquarters is still a pretty buttoned-down place. True, the vending machines in the corridors are stocked with—what else?—Heineken. But they're programmed not to dispense the brew until after 4 p.m. "Not much has changed" since Charlene's father, Alfred H. "Freddy" Heineken, ran the company, says Ruys, a 56-year-old former Unilever executive. Ruys was elevated to the top job 10 years after joining the company, a relatively short tenure

by Heineken standards. Freddy, a hard-nosed businessman with a zest for life, passed away last year at the age of 78. And while no one from Ruys on down would dare dishonor his memory by claiming that anything as radical as a revolution is in the making at Heineken, there's an unmistakable whiff of change in the air.

It's about time, too. The world's No. 3 brewer, with \$11 billion a year in sales, can no longer take for granted the strengths that have made its squat green bottle the envy of the business. Budweiser may have crowned itself the "King of Beers," but it only reigns in the U.S. Heineken, recognized everywhere from Houston to Hong Kong, is the closest there is to a global beer brand. That's an achievement none of the top brewers, from No. 1 Anheuser-Busch to No. 2 SABMiller and No. 4 Interbrew, have been able to match.

Trouble is, the \$367 billion world beer



market is changing. Beer consumption is declining in the U.S. and Europe, source of two-thirds of Heineken's profits, because of tougher drunk-driving laws and a growing appreciation for wine. At the same time, the beer marketplace is becoming ever more crowded thanks to a flood of new brands, from low-carbohydrate brews to Italian and Czech imports. But the number of players is shrinking. Heineken, one of the first European brewers to realize the value of cross-border deals, now is falling behind more aggressive rivals.

To overcome these challenges, Ruys is pushing Heineken to break out of its play-it-safe corporate culture. Freddy had a knack for marketing, but he

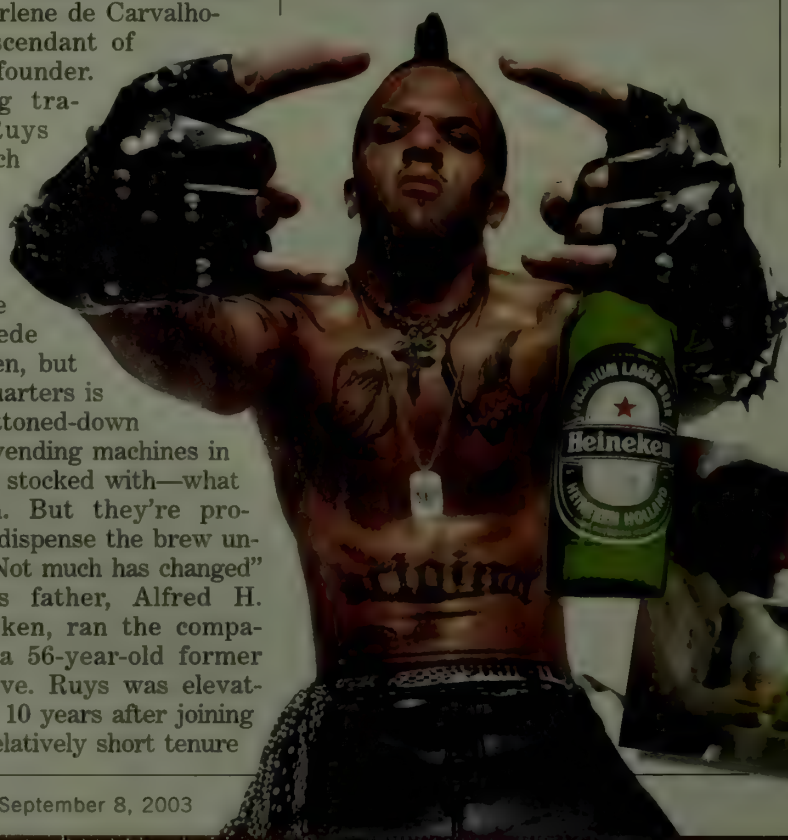
TWO TARGETS

The brewer hopes to widen appeal without alienating core customers

financially conservative and in earlier years. Heineken has even as SABMiller and Interbrew grew through ticket acquisitions. Heineken's full success will

depend on justifying Freddy's spirit while meeting the challenge that he never anticipated.

Ruys is ready to make his mark.





AMSTERDAM PUB

Twentysomethings are a market not yet fully tapped

ancing act—reaching out to younger customers without alienating the middle-aged beer drinkers who are the company's core market. "[Heineken] is in danger of becoming a tired, reliable, but unexciting brand," warns John A. Quelch, a Harvard Business School professor who has studied the beer industry.

That's why Heineken's flagship is getting a marketing makeover. The company has arranged tie-ins with big-budget youth films, such as *The Matrix: Reloaded*, and sponsored events such as a sweepstakes where winners got to attend a house party in Jamaica. Yet management has been careful not to

lled out more than \$3 billion last r for a dozen acquisitions, most noly BBAG, a family-owned brewer ed in Linz, Austria. Once the \$2.1 a BBAG deal closes later this year, neken will be the No. 1 beermaker even countries in Eastern Europe. a bid to capture the sought-after ntysomething segment, advertising packaging are becoming more dar. Witness the recent debut of neken's silver-and-green aluminum ttle," which sells at trendy clubs in rope and the U.S. for three times price of Heineken on tap. "Our ategy is right, but we can be sharp- after so many years of success," s Ruys.

That success is no longer guaranteed. The convergence of a weak global econy, an unusually rainy summer in the S., and SARS, which emptied watering es across Asia, will break a six-year a of double-digit profit growth. Then re's the strong euro, which is crimp- earnings from the U.S., a market t accounts for a quarter of all profits. alysts now estimate the company will t barely match last year's net profit \$900 million on sales of \$11.6 billion. t even in the face of all these obsta- s, the Dutch brewer has managed to end its global market share of 7%. e brand Heineken is as healthy as it s ever been," concedes Joseph J. ch Jr., who imports rival Dutch lager olsch into the U.S.

Others are not so sure. Some worry

the company could face years of flat sales. "We are nervous that what some commentators see as a one-off blip could be rather fundamental," says Ian Shackleton, a London-based analyst for Credit Suisse First Boston, which rates Heineken "underperform." Over the past 12 months, Heineken's share price has declined 10%, to just under \$37.

Top management in Amsterdam is not quite panicked, but there's definitely a sense of urgency seeping into the ranks. Heineken's boss is resorting to tough tactics to stir the troops out of their complacency. A video produced for staff viewing only features a young Italian man saying: "I hate beer." The message: Heineken needs to win over consumers who have not yet developed a strong loyalty to a particular beverage. That's why Ruys and his lieutenants have been traveling to places like Madrid and Shanghai to down a cold one with groups of randomly selected young people.

It's a tough bal-

stray into the testosterone-soaked territory that is the domain of rivals like Adolph Coors Co. The strategy has started to pay off in the U.S., where the average age of the Heineken drinker has descended from about 40 in the mid-1990s to the early 30s today. Ruys's goal is to push that down into the high 20s in coming years.

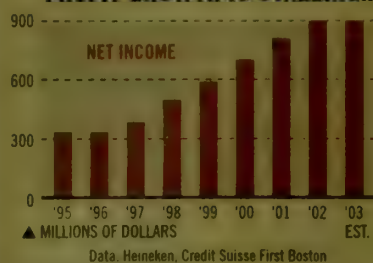
Heineken's not the only company trying to score with twentysomethings. Today's beer drinkers are awash in a sea of choices. Consider the \$67 billion U.S.

market, probably the most keenly contested of all. There, Heineken beer and its sister brand, Amstel Light, which together have about 22% of the market, are under attack from an ever-growing constellation of imports and malt-based drinks such as Smirnoff Ice and Sky Blue. Americans developed a taste for thirst-quenching Corona while vacationing in Mexico, helping the brand overtake Heineken in the late 1990s to become the top import in the U.S.

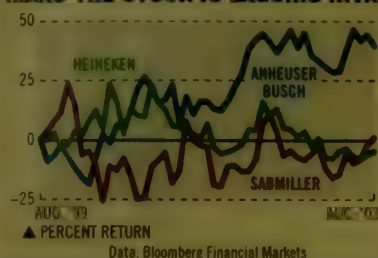
Meanwhile, SABMIL-

IS BIG GREEN GOING FLAT?

PROFIT GROWTH IS STALLING...



AND THE STOCK IS LAGGING RIVALS



ler, the product of last year's merger of South African Breweries and Milwaukee-based Miller, is pushing its Czech-brewed Pilsner Urquell, while Brussels-based Interbrew is making inroads with Stella Artois. Even Anheuser-Busch, which already commands an eye-popping 52% of the domestic market, is playing the import game: Anheuser World Select, which was launched earlier this year, is fashioned from imported hops and

Now Heineken plans to take a breather, according to company execs. "We are interested in growing, but not at any price," says Ruys. Heineken has dropped out of the bidding for German brewer Brau und Brunnen, whose stable of national brands is likely to fetch a hefty premium over the company's \$430 million stock market value.

Tightfisted Freddy would probably also have balked at paying so rich a price. But these days it's his only child and heir, Charlene, 49, and her husband, former Olympic skier Michel de Carvalho, who call the shots.

As Heineken's con-

figures that Heineken won't recover the cost of capital until 2007 at the earliest.

Publicly, the Heineken heiress has vowed to keep the company independent. Last year, addressing shareholders of Heineken Holding, the separately traded company that controls just over 50% of the operating entity Heineken NV, she said: "We are a part of [Heineken's] past, its present, and its future." Yet industry insiders speculate that Freddy's daughter might be willing to sell the family jewels if the price was right. A hostile takeover would be impossible under Heineken's ownership structure. "Our mission is to hand a healthy company to the next generation," says de Carvalho, who rules out any sale.

Despite last year's changing of the guard, the past remains very much present at Heineken. It's all about evolution—not revolution. The company's advertising is refreshingly offbeat, a

CEO Ruys is trying to ready a tradition-bound company for a changing marketplace

comes in a green bottle suspiciously similar to Heineken's. There's a reason why the premium market is getting so crowded. Total beer consumption in the U.S. has declined 1% since 2000, amid tighter drunk-driving laws. But during that time, imports have grown 16% as consumers choose quality over quantity.

The U.S. is just one battleground. The beer industry is in the midst of a furious wave of consolidation. The business is more fragmented than most: The top four brewing companies have less than a third of the global market. By comparison, the top four spirits makers control half the world market. But that's changing as beermakers scramble to acquire strong local brands and the distribution networks that go with them. "The era of global brands is coming," says Alan Clark, Budapest-based managing director of SABMiller Europe, which snapped up Italy's Peroni in May.

Heineken has a head start there. It ranked second only to Budweiser in a global brand survey jointly undertaken by *BusinessWeek* and Interbrand earlier this year. Heineken "is recognized everywhere," says Kevin Baker, director of alcoholic beverages at British market researcher Canadean Ltd.

No company can afford to pin its entire fortune on a single product, however. That's why, after years of standing on the sidelines as competitors snatched up choice brands in emerging markets, Heineken has embarked on its own shopping spree, pouncing on brewers in places like Panama, Egypt, and Kazakhstan. In Egypt, Ruys bought a majority stake in Al Ahram Beverages Co. and hopes to use the Cairo-based brewer's fruit-flavored, nonalcoholic malts as an avenue into other Muslim countries.

trolling shareholder, the London resident and mother of five retains a say over a range of business decisions, from new packaging to acquisitions, though she is nowhere as involved as her father was. "Must-have strategic acquisitions will always be looked at," says Michel de Carvalho, 59, a member of Heineken's supervisory board and vice-chairman of investment banking at Citigroup in London. (De Carvalho traditionally speaks for the family.) Proof of that is Heineken's decision to cough up more than \$2 billion for BBAG. Deutsche Bank

HEINEKEN'S WORLD

The Dutch brewer operates in 170 countries, and its portfolio includes dozens of lesser known local brands. Below is a sampling:

NETHERLANDS	Heineken, Amstel, Kylian, Lingen's Blond, Murphy's Irish Red
U.S.	Heineken, Amstel Light, Paulaner (wheat beer), Moretti
CHINA	Tiger, Reeb*
SINGAPORE	Heineken, Tiger
FRANCE	Heineken, Amstel, Buckler (nonalcoholic), Desperados (tequila-flavored beer)
GERMANY	Paulaner, Kulmbacher, Thurn und Taxis
ITALY	Heineken, Amstel, Birra Moretti



POLAND	Heineken, Zywiec
KAZAKHSTAN	Tian Shan, Amstel
PANAMA	Soberana, Panama
EGYPT	Fayrouz (nonalcoholic)
ISRAEL	Maccabee, Gold Star*
NIGERIA	Amstel Malta, Maltina

*Minority interest

Data: Heineken

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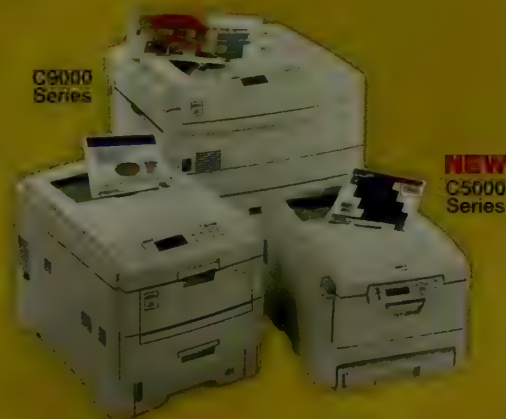
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nod to Freddy's wry sense of humor. One commercial in the U.S. showed a young man plunging his arm deep into a barrel filled with ice and bottled beer. He gropes around fruitlessly until his whole body begins to shiver. Finally, he hauls out a Heineken. Popping it open, he joins friends—who are also gripping Heinekens and shivering. "They've done a very good job of not being snooty—using accessible jokes and imagery to con-

BusinessWeek online

For an interview with Heineken CEO Anthony Ruys, go to www.businessweek.com/magazine/extra.htm

vey the idea that this beer is a cut above," says Bob Garfield, ad critic of trade weekly *Advertising Age*.

The Dutch brewer is stepping up marketing to Hispanics, who account for one-quarter of U.S. sales. A new Spanish-language spot shows a group of men playing dominoes. They pause for a moment as one of them demonstrates how to pour a glass of beer without stirring up too much foam. "Heineken is for professionals—in beer," says a voice-over. "We want to bring over the values of the brand in a different way," says Frans van der Minne, president and CEO of Heineken USA Inc.

Heineken may move a little

slower than its competitors, but no questions its staying power. "It takes a long time to build a brand. People are not prepared to put that time says Sir Frank Lowe, founder of London-based Lowe & Partners Worldwide, which handled Heineken advertising in Britain and the U.S. until a conflict with another client, Interbrew, emerged. Heineken, he says, "has the will and patience to stick it out." Looks like slow pour could still win in the end.

By Jack Ewing in Amsterdam, Gerry Khermouch in New York

THE HOUSE THAT FREDDY BUILT

Alfred H. Heineken died in January, 2002, at age 78, but the influence of "Freddy" at the company remains pervasive. Heineken CEO Anthony Ruys can feel it every time he opens the door to his office—it weighs a ton. That's because Freddy, after being kidnaped in 1983, ordered that the executive suite be bullet-proofed. Luckily, the Dutch beer baron survived the three-week ordeal with his humor intact. "They tortured me," Freddy told Sir Frank Lowe, chairman of former Heineken ad agency Lowe & Partners Worldwide. "They made me drink Carlsberg!"

Although he was born into wealth, Freddy proved early on that he was one tough rich kid. Heineken was built by his grandfather, Gerard Adriaan Heineken, who in 1864 bought out a four-century-old Amsterdam brewery. But by 1942, debt, divorce, and bad management had deprived the Heineken family of majority control. By secretly buying up shares, 30-year-old Freddy regained control in 1954. "I wanted to prevent strangers from doing strange things under my name," he said at the time.

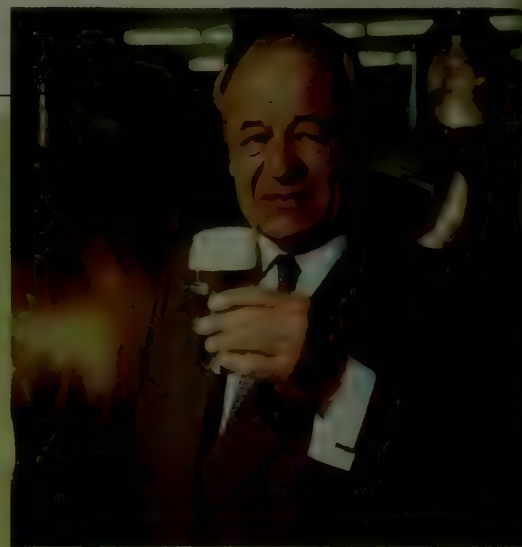
When it comes to the golden brew, Freddy was a visionary. He realized that beer can travel and expanded into countries such as France and Italy, turning Heineken into Europe's biggest brewer. "He saw much earlier

than others that Europe was going to be a continent," says Heineken biographer Barbara Smit. In partnership with distributor Leo van Munching Sr., Heineken became the leading imported beer in the U.S. Then, in 1968, Freddy engineered the takeover of Dutch rival Amstel. While Heineken remains the flagship brand, middle-market Amstel and its sister Amstel Light have carved important niches in places like Greece and the U.S.

A bon vivant who piloted his own plane and hosted the Dutch royal family aboard his yacht, *Something Cool*, Freddy had an adman's pizzazz. It was he who decided to dress Heineken in green—rather than the customary brown—and tip the "e"s slightly, to give the label a more friendly look. Yet the Netherlands'

richest man was also famously tightfisted. Nico Nusmeier, who heads Heineken's operations in Poland, recalls how the boss cracked jokes and high-fived workers during a visit to a new bottling line years ago. "At the same time, he knew bloody well whether we had overinvested or not," says Nusmeier.

Freddy gave up his post as chairman of the company's management board in 1989 but contin-



THE PATRIARCH

Freddy in 1992: He made Heineken No. 1 in Europe

ued to live a few doors down from Heineken's headquarters and speak frequently with his successor, Karel Vuursteen. When Heineken had a chance to buy South African Breweries PLC in the late 1990s, Freddy nixed the idea. That may have been a mistake: Last year, SAB acquired Miller Brewing Co. in the U.S., overtaking Heineken in global sales.

After Heineken's death, majority control passed to his only child, Charlene de Carvalho-Heineken. Charlene, who studied law in college, clearly takes a keen interest in the company but is not involved in day-to-day management.

That may be a good thing. Freddy was insistent on preserving the integrity of the Heineken brand—perhaps too insistent. Since his death, "people feel freer to play around with the brand," says Smit. That extra maneuvering room could be essential as Heineken struggles to attract younger beer drinkers.

By Jack Ewing in Amsterdam



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SHIFT_expectations

PLAYING GOOD COP TO RUPERT MURDOCH

How Peter Chernin, News Corp.'s affable No. 2, keeps the wheels oiled at the sprawling media empire

Rupert Murdoch couldn't make the media schmoozefest that investment banker Herbert A. Allen holds every July in Sun Valley, Idaho. Murdoch's third wife, Wendi Deng, was expecting their second child, and the 72-year-old News Corp. chairman decided to stay close to home. That may have been for the best: Without Murdoch there bigfooting the other moguls, his No. 2, Chief Operating Officer Peter Chernin, had a chance to sweet-talk them. The affable, 52-year-old Chernin tried to assure the other media barons that the boss, only months away from closing his \$6.6 billion deal to buy control of DirecTV Inc. satellite service, wanted to play nice. He wouldn't muscle out competitors or drive up the cost of his company's Fox movies, TV shows, or sports programs. At lunch with Brian L. Roberts, the head of cable giant Comcast Corp., Chernin promoted several Fox channels that Comcast could carry. And he promised Walt Disney Co. President Robert A. Iger that DirecTV intended to carry new channels from Disney's ESPN network.

Peter Chernin is Rupert Murdoch's alter ego: a soothing presence who balances the autocratic, often intimidating tycoon. Chernin, a big political contributor, is even in the Democrats' good books. As Murdoch builds a global empire, Chernin's behind-the-scenes role has never been more crucial.

Chernin deals with Hollywood, a state

of mind as much as an industry that Murdoch disdains and admits he doesn't fully understand. Chosen by Murdoch to run Fox Entertainment Group (which is 80% owned by News Corp.) in 1998, Chernin is stepping up production of programs and launching cable channels that Murdoch's satellite armada will beam to Asia, Europe, and now the U.S. At the same time, he is trying to keep the peace with the cable and satellite operators who fear News Corp.'s growing clout. The company is at odds with EchoStar Communications Corp.'s combative Chairman Charles Ergen, a longtime Murdoch foe, over Ergen's refusal to pay more for cable channel FX. Rather than pull the channel—and “go to war,” as Chernin puts it—he has twice extended a grace period while the two companies negotiate. Chernin is also working to keep the DirecTV deal on track in Washington. “He’s a great salesman,” says Murdoch. “And there are things he can do that frankly I’m not as qualified to do.”

That includes impressing Wall Street, which had watched with dismay as Murdoch made one expensive deal after another, bringing the company close to bankruptcy in the early 1990s. “Peter gives us a lot of confidence that the place is run well,” says Merrill Lynch & Co. analyst Jessica Reif Cohen. To increase News Corp.'s film and TV production, Chernin started low-cost units that found such low-budget hits as the film *Bend It Like Beckham* and today are replicating the popular reality-TV show *Joe Millionaire* in several other nations. He also makes Fox's disparate operations work together. To help promote the DVD releases of the second season of the TV show *24*, he pressed marketers to delay

the introduction so that star Kiefer Sutherland could hawk the DVDs on Fox's first weekend of NFL games in September.

Chernin's strategies have helped turn Fox Entertainment into the fastest-growing part of News Corp., accounting for 75% of its overall operating earnings. For the year ended June 30, the company recorded net income of \$1.1 billion on revenue of \$17.5 billion. Last year, its profits came to \$636 million before a \$6.9 billion writedown for investments in Gemstar TV-Guide International Inc. and other companies. Since January, News Corp.'s stock is up 25%, to around 33, better than the Bloomberg Media Index average return of 14%. Indeed, for his programming smarts, organizational discipline, and singular ability to get along with Murdoch, Chernin earned \$14.6 million in salary and bonus last year, plus \$2.6 million in stock options.

His role at News Corp. has not gone unnoticed by the media Establishment. Industry insiders say that when Disney's Michael D. Eisner was under fire last year, some board members sounded Chernin about the job. He was also mentioned as a possible CEO for Vivendi's Hollywood unit. But as for running News Corp., that's another story. Murdoch, who controls 30% of the company, is grooming his 31-year-old son, Lachlan, now Chernin's deputy, for



RAPPORT: MURDOCH AND CHERNIN

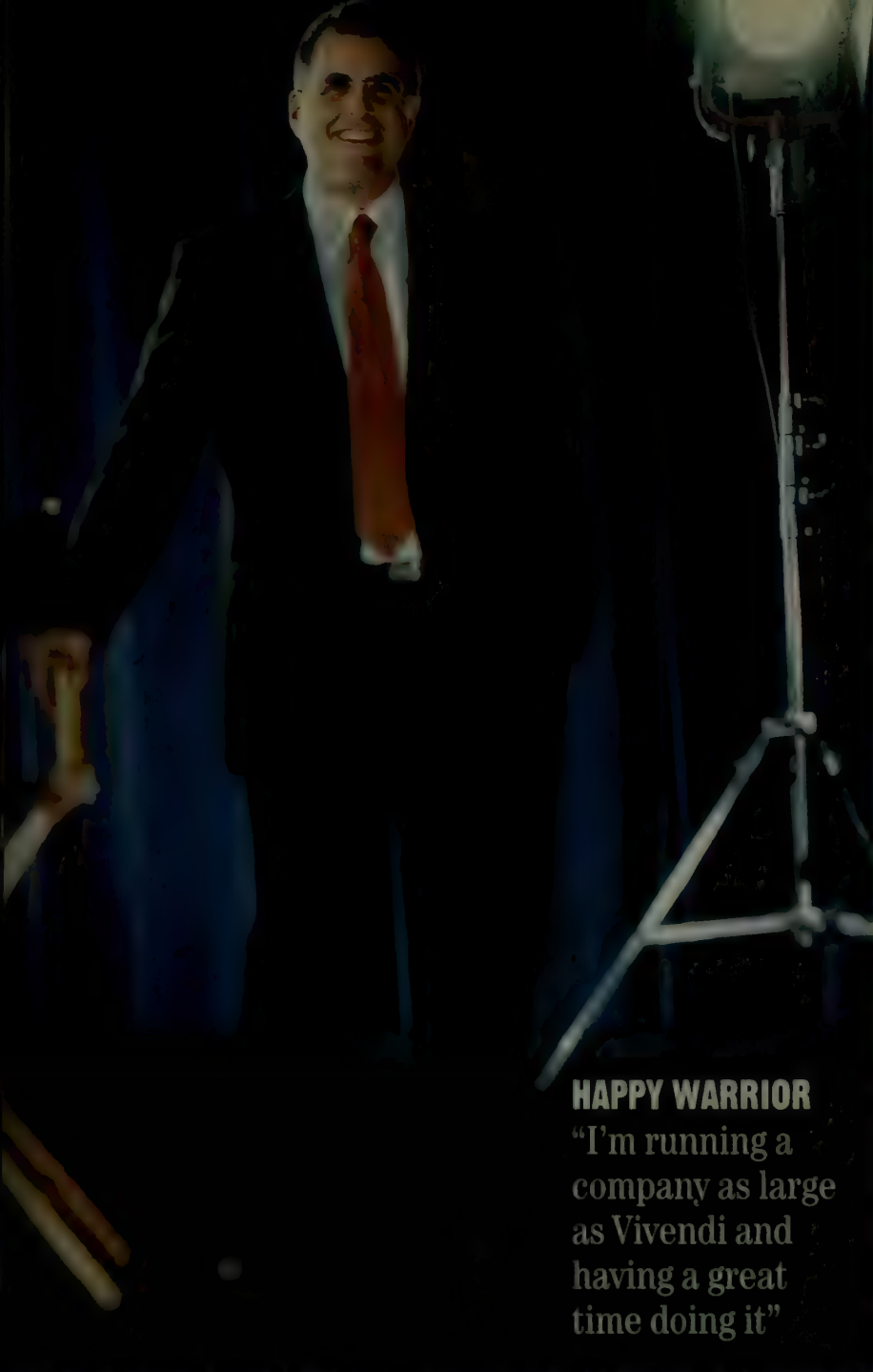
PETER CHERNIN

BORN May 29, 1951, in Harrison, N.Y.

EDUCATION B.A., English literature, University of California at Berkeley, 1974

CURRENT POSITION Rupert Murdoch's second-in-command at News Corp.

EARLY YEARS He was the guy with the audio visual equipment at his school in suburban New York. An antiwar activist, he went door-to-door handing out literature urging U.S. withdrawal from Vietnam.



HAPPY WARRIOR

"I'm running a company as large as Vivendi and having a great time doing it"

job. And Chernin seems O.K. with for now. "I'm running a company as e as Vivendi and having a great time g it," he says. hat's hardly what those who knew when he was growing up in the s in Westchester County, N. Y., would e thought. TV viewing in the Chernin ehold was restricted to an hour a k. As for media pretensions? "He the AV guy, who ran the overhead ector," recalls movie producer Lynda t, a high school friend. An English

major at the University of California at Berkeley, Chernin went to work as an editor at Warner Books in New York.

From there, Chernin moved to Hollywood to make TV movies of the week for producer David Gerber. After stints at Showtime and Lorimar Films, he was hired by former Fox Chairman Barry Diller in 1989 to head programming for the company's two-day-a-week TV network and produced shows such as *In Living Color* and *Beverly Hills 90210*. He also became a Murdoch favorite:

PATH After stints at e and Lorimar Films, he joined network in 1989 as its top ner. Became chairman of the io in 1992 and News Corp. president in 1996.

LUCKY BREAK Impressed Murdoch when he gave the boss a lift back to L.A. after a company retreat in 1990.

WHY MURDOCH LIKES HIM Chernin is Murdoch's alter ego:

When the boss asked Chernin for a ride back to Los Angeles after a company retreat in Santa Barbara, the young executive impressed Murdoch with his grasp of TV economics.

Chernin moved up the ranks at Fox, displaying political smarts that insiders say allowed him to stay on the right side of Murdoch even as the Fox network's ratings faltered. In 1992, Murdoch moved him to the film studio where Chernin oversaw production of such hits as *Speed*, *Independence Day*, and *Titanic*, a film that became notorious for how far over budget it ran. "It cost \$115 million for about five minutes," recalls Chernin, who was forced to sell off half the rights to Paramount as its budget climbed to \$210 million. The film eventually became one of the most profitable in Hollywood history.

By then, Chernin had become Murdoch's second-in-command and primary trouble shooter. It was Chernin who forced studio chief Bill Mechanic to resign in 2000 after a string of flops. Last year, Chernin negotiated the forced resignation of Henry Yuen, the embattled chairman of Gemstar, in which News Corp. holds a 42% stake. Yuen has since been sued by the Securities & Exchange Commission for allegedly inflating Gemstar's earnings. Yuen denies the charges.

Chernin's most notable achievement as the enforcer, though, was getting the best of Disney in a big deal. Chernin sold the Fox Family Channel to Disney in 2001 for \$5.2 billion, holding his own against Eisner, a famously tough negotiator. Later, Eisner admitted he overpaid—by some \$1 billion, according to industry experts. "Peter just kept his cool, even when Eisner and those guys started doing their stuff," recalls Haim Saban, News Corp.'s partner in the channel.

The deal was a classic demonstration of the Murdoch-Chernin modus operandi. Murdoch struck the deal with Eisner; Chernin kept it from falling apart. The question now is how long the partnership can last. Chernin has pushed for more visibility lately, taking the lead on Hollywood's effort to rein in piracy and appearing at investor conferences instead of Murdoch. Both Murdoch and Chernin downplay the succession issue, but Chernin knows that if he wants to be boss, he'll most likely have to go somewhere else to do so. And then the man who's known as "Murdoch lite" would get to take on Murdoch himself.

By Ronald Grover in Los Angeles

Diplomatic, jovial, easygoing, and a big fund-raiser for the Democratic Party.

FAMILY Lives in Santa Monica, Calif., with wife, Megan, two college-age sons, and a teenage daughter.



STRATEGIES

FORD'S NEW PICK-ME-UP?

The carmaker has a lot riding on its retooled F-150

In Casper, Wyo., Jack Harbison says he can hardly wait for the arrival of his new white 2004 Ford F-150 fully loaded SuperCab pickup truck. The 75-year-old drilling contractor, a Ford customer for 35 years, ordered the \$40,000 truck in April, sight unseen. New F-150s have just begun rolling out of Ford Motor Co.'s Norfolk (Va.) factory, and he plans to grab his as soon as it arrives at his dealer, probably in early September. Says dealer Pete Greiner: "He's like a little kid waiting for Christmas."

Die-hard customers such as Harbison should help the latest generation of Ford's biggest-selling vehicle get off to a

strong start. That's crucial for the troubled auto maker's bottom line. Profits on the current F-150 average \$10,000 per vehicle—leaving Ford with about \$3 billion in profits on the 600,000 vehicles sold per year, after subtracting corporate taxes and money spent on incentives. (Those profits offset only some of the losses in passenger cars and overseas units. Ford lost \$980 million overall last year.) Chief Executive William C. Ford began 2003 by telling investors that of all the new-vehicle launches, none is as essential to Ford's success as the F Series.

But despite eager customers and ear-

ly positive reviews, it's unlikely Ford will get as big a profit kick on his new pickup as he's hoping for.

Early buyers will snap up creative top-of-the-line versions with few, if any, rebates. But profits will certainly start eroding next year, as General Motors Corp. tightens its price pressure and a highly anticipated new full-size pickup from Nissan Motor Co. enters the market. To face those challenges, Ford launched the 2004 F-150 with upgrades from new interiors to more refined engines. But that lifted the F-150's per-vehicle manufacturing cost by \$2,000, which was later cut to \$1,000. Only a fraction of that is being passed over to the \$22,010 base price. That means that the 2004 truck will have a gross profit about 10% less than the 2003 model, figures UBS Securities analyst Saul Rubin.

Earnings could suffer even more if the new F-150s lose their novelty. Ford will continue to sell the older, more profitable version of the F-150 through next summer. But many analysts expect Ford will have to start increasing incentives as early as this winter to meet the stiffening competition. By next year, give-backs could top \$2,000 on the new truck and \$4,000 on the older model. "The truck may provide temporary relief," Rubin writes in a recent report. "But this may change, and quickly."

For years, big pickups and SUVs were exempt from the auto industry's price wars. No longer. For instance, Ford notes, Ford launched updates of the F-150 and Lincoln Navigator last year with only modest givebacks. Then, however, it has had to burn through incentives on the big sport-utility vehicles. On the F-150, that's \$4,000 and nearly \$7,000, respectively. GM's determination to preserve market share, it raised incentive on the Chevy Silverado to about \$3,900 in July. That bodes ill for Ford's play for rein in rebates on the new F-150. Ford can bet GM is well aware of the

A TRUCK FULL OF GOODIES

The latest F-150 is loaded with upgrades—but the higher cost of the new design will cut into profits



2004 FORD F-150

	2004 F-150	OLD MODEL F-150
V-8 BASE PRICE	\$22,010	\$21,765
INCENTIVES	None, but analysts say they could top \$2,000 next year	About \$3,000, rising to estimated \$4,250 in 2004
UNIT SALES*	167,000 in 2003, 525,000 in 2004	388,000 in 2003, 110,000 in 2004
GROSS PROFITS PER VEHICLE**	\$8,975	\$10,000

*Estimated North American sales, per calendar year

Data: Company reports, Ward's Automotive Reports, UBS Investment Search

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cost problem and sees an opportunity to take Ford's revenue away," says auto consultant Jim Bulin.

Now even the Japanese are using givebacks to sell trucks. Toyota Motor Corp. offers \$2,000 off of its Tundra, and Nissan says it will offer incentives on its beefy new Titan, set to launch in December, though it has not said how much. The Titan is being watched closely by the industry—with a 5.6-liter V-8 engine, it's the first true full-size Japanese pickup geared to American tastes.

Ford has responded by packing more goodies into its new F-150. The company spent lavishly on the F-150's makeover. It developed a more powerful V-8 engine and will drop the V-6 altogether. It gave the truck a stiffer body frame to improve durability, ride, and handling. New F-150s all have four doors, and there are five distinct styles, from sporty off-roader to cushy luxury cruisers, each with top-notch interiors. But even Bill Ford is questioning whether the extras are too much for the market to bear. "We let in a lot of cost that the customer isn't willing to pay for," he says of Ford's spending on many of its vehicles.

Ford admits it will take two to three years to get the new F-150's cost on a par with the outgoing truck, perhaps by tweaking components and materials. Weighing those extra costs against consumers' "let's-make-a-deal" mind-sets, Ford raised prices on the new pickup by a range of only \$245 to \$635 from comparably equipped 2003 trucks. Yet Ford Div. President Steve Lyons swears the new F-150 will actually earn slightly fatter profits: "We anticipate incentive costs will be substantially lower and the mix will be better."

But even if Ford wrings out all the extra costs, it's difficult to see how it can command much of a premium with all the new trucks coming to market. Toyota is expanding output on its Tundra to 250,000, and Nissan will churn out 100,000 Titans. Meanwhile, growth in the 2.3 million-vehicle-per-year large pickup market has been meager. Says Lincoln Merrihew, auto specialist at researchers Compete Inc.: "We're going to see a battle royal."

Ford needs every dime of profit it can get from the F-150. Ford's new car designs are a year away, and it is still sorting out problems in its luxury-car group. So management can't afford costly delays or quality defects in the F-150. Earlier this year, Bill Ford vowed: "We will nail the launch of this product." But Ford's truck unit is headed down a bumpy road, and competitors will be eager to see it stall out.

By Kathleen Kerwin in Detroit

The Workplace



VANCE MERCEDES PLANT: DaimlerChrysler will stay neutral on union drive.

AUTOS

THE UAW: USING TRADE-OFFS TO GAIN TRACTION

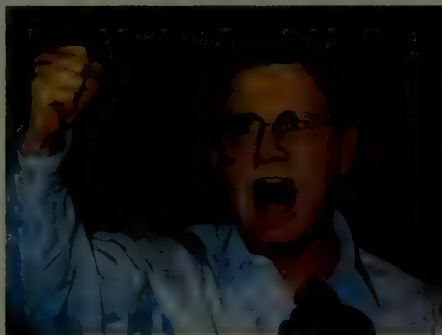
It's helping Detroit cut costs in exchange for membership growth

The outlook for Detroit auto makers is fairly grim these days. They've lost billions of dollars in the rough market of the past two years, and they have few hot new models on the horizon to bail them out. The Big Three also continue to lose market share to Japanese rivals whose younger workforces don't burden them with the billions in retiree pension and health costs that weigh down U.S. carmakers. Nor is Detroit likely to get significant help from the United Auto Workers when its labor pacts expire on Sept. 14. The union blames the companies' woes on poor management and has no intention of slashing members' rich wages or benefits to bail them out.

Despite the hard line, though, the UAW and the Big Three have inched in the past year or two toward some new common ground. The union has agreed to allow GM, Ford, and Chrysler to shed thousands of jobs through buyouts, attrition, and by outsourcing work to low-

er-wage parts suppliers. In effect, union leaders are helping auto makers to restructure by turning over parts that pay \$22 an hour to suppliers who pay just \$14. Overall, the Big Three likely to dump nearly 50,000 jobs in 2007, or about one-fifth of their collective workforce, estimates Sean McAlin, labor analyst with the Center for Automotive Research in Ann Arbor.

In return for accommodating restructuring, the UAW persuaded Detroit to help bolster its depleted membership, which has slid to the 1.5 million members it had 20 years ago. The union gained the most in this swap at



GETTELFINGER: CUTTING DEALS

parts suppliers, which the auto makers have leaned on to meet the UAW's demands for hands-off behavior in union organizing drives. The most recent example: In mid-August, Dana Corp., which produces everything from chassis to brakes, announced a so-called neutral pact with the union, agreeing to forgo formal union elections and allow the

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The Workplace

to launch organizing drives without management opposition. The UAW already has won more than 10,000 new members since 2001 through similar deals with parts makers Johnson Controls Inc. and Lear Corp. "We're concerned about keeping the Big Three competitive," says UAW Vice-President Bob King, who's in charge of organizing. "But we're also concerned about the future of the union."

The jobs-for-members swap also may help the UAW crack its decade-long goal of unionizing the foreign transplants. After more than four years of conflict, the union finally has persuaded DaimlerChrysler Corp. to remain neutral in sign-up drives at its nonunion U.S. factories. UAW President Ronald A. Gettelfinger and Vice-President Nate Gooden reached a secret understanding with DaimlerChrysler officials at the company's headquarters in Stuttgart, Germany, last fall, *BusinessWeek* has learned.

That paved the way for the union to quickly sign up 3,100 workers at two truck plants in North and South Carolina that belong to Freightliner Inc., a DaimlerChrysler subsidiary—with little public notice. The UAW plans to follow suit at the truckmaker's other two U.S. factories, then move on to the big prize: the Mercedes factory in Vance, Ala., which opened in 1996. Skittish company and UAW officials decline to speak publicly about the deal, although the UAW's President King, who's in charge of organizing, makes no secret of his plans to go after the transplants. "We can only maintain good wages and benefits at the Big Three if their competition is paying [them]," too, says King.

The impact of all these moves could soon be felt across the industry. While the union isn't likely to grant immediate relief in its new contracts, the Big Three will see their costs decline as suppliers make and assemble more parts. The suppliers themselves face higher expenses, since many now pay as little as \$10 an hour for nonunion labor. But that could be offset by the added business they

will be getting from the Big Three.

Long term, even the transplants could be affected. Their \$500-per-vehicle labor cost advantage vs. Detroit could begin to erode as the UAW lifts the price of labor for parts, since the transplants buy many of their parts from the same U.S. suppliers. And if the UAW finally succeeds in unionizing Mercedes' 2,100 Vance workers, the union could gain enough psychological momentum to sign up workers at the other transplants, labor experts say. The union has failed repeatedly to

kept quiet as Chrysler has made plans to sell up to five parts plants. Still, it took four years for DaimlerChrysler German execs to accept the trade-off. In 1999, both Freightliner and Mercedes mounted stiff opposition to UAW organizing drives, defeating them handily.

This time around, when Freightliner agreed to neutrality, top brass also joined union organizers at worker meetings to drive home the point that management wasn't fighting the union. "Management made it clear that

the plant would be competitive" even if workers joined the union, says one UAW organizer involved in the campaign. Still, unionizing the transplants won't be easy even if the UAW wins at Mercedes, as union officials expect to do after the current contract talks. After all, the union has nothing to trade with Japanese for labor peace.

Where the union's leverage is with parts makers. Back in 2001, Johnson Controls, which makes seats and auto interiors, agreed to stop fighting unionization, partly under pressure from Ford, a major customer that wanted to maintain peace with the union. The UAW has since organized nine Johnson plants. Daimler is already partly unionized; the union now hopes to recruit the rest of its workers.

The suppliers are thrilled to accept unionization. But they say they can stay competitive as long as the UAW doesn't try to hold them to the \$22 the Big Three pay. Says one parts executive, "If they get greedy

will be disastrous for the union and companies."

Clearly, the UAW has much ground to regain. Detroit's market share—hence the UAW's—fell to 60% this year as the transplants grabbed more sales. In parts, the union now represents just 23% of the workforce, down from 51% in the late 1970s. Unless it can turn those numbers around soon, its contract talks with the Big Three may look more like begging than bargaining.

By David Welch in Detroit

A UNION MOVING BEYOND THE BIG THREE?

After many ups and downs at parts suppliers and transplants, the UAW appears to be making headway

JAN., 1997 UAW workers strike at two Johnson Controls seat-making plants in Ohio. When the company tries to hire strikebreakers, its primary customer, Ford Motor Co., refuses to take the seats, thus pressuring Johnson to give in to the union.



JOHNSON CONTROLS STRIKE

MAY, 1999 Lear Corp. agrees to remain neutral in UAW recruitment drives, allowing the union to sign up 4,000 workers at 14 auto-parts factories the company acquired.

DEC., 1999 The UAW starts a recruitment drive among Toyota's 9,000-worker plant in Georgetown, Ky., but withdraws

without an election the next year due to lack of support.

OCT., 2001 After management resistance, 6,300 Nissan workers in Smyrna, Tenn., vote two-to-one against the UAW. It was the fourth failed unionization attempt in 12 years.

JUNE, 2002 To end strikes at four parts plants, Johnson pledges neutrality at 26 factories employing 8,000 workers; about 1,000 have joined the union so far.

JAN., 2003 After four years of talks with the UAW, DaimlerChrysler agrees to stop opposing unionization in the U.S. Some 3,100 workers join the union at two of its Freightliner truck plants in North Carolina. The UAW expects to sign up 2,100 Mercedes workers in a nearby Alabama factory.

AUG., 2003 Auto-parts maker Dana Corp., already partly unionized, pledges neutrality in UAW campaigns.

win unionization elections at Nissan Motor Co. and Honda Motor Co. over the past decade. But unionizing even a few would begin to even out the competitive footing across the industry. "The union desperately needs a win" among the transplants to maintain its ability to set wages, says McAlinden.

That desperation is behind the union's willingness to trade the loss of higher-wage, company-run parts plants for a leg-up with organizing in the union-hostile South. In recent years, the UAW has

YELLOW: BURNING UP THE ROADWAY?

Zollars bets an acquisition will help it take on UPS and FedEx

Yellow Corp. Chairman and Chief Executive William D. Zollars is gearing up for an aggressive passing maneuver. The Overland Park (Kan.) trucking company is buying its slightly bigger rival, Roadway Corp., the industry's second player, in a \$1.1 billion deal that is expected to close by yearend. The move will create a North American giant with 50,000 employees, 18,700 trucks, 69,300 trailers, and yearly revenues of nearly \$6 billion—or roughly one-third of a \$30 billion industry known as over-the-road truckload delivery. LTL shippers pick up smaller shipments, consolidate them at terminals, and then load them into trailers for long-haul off one by one.

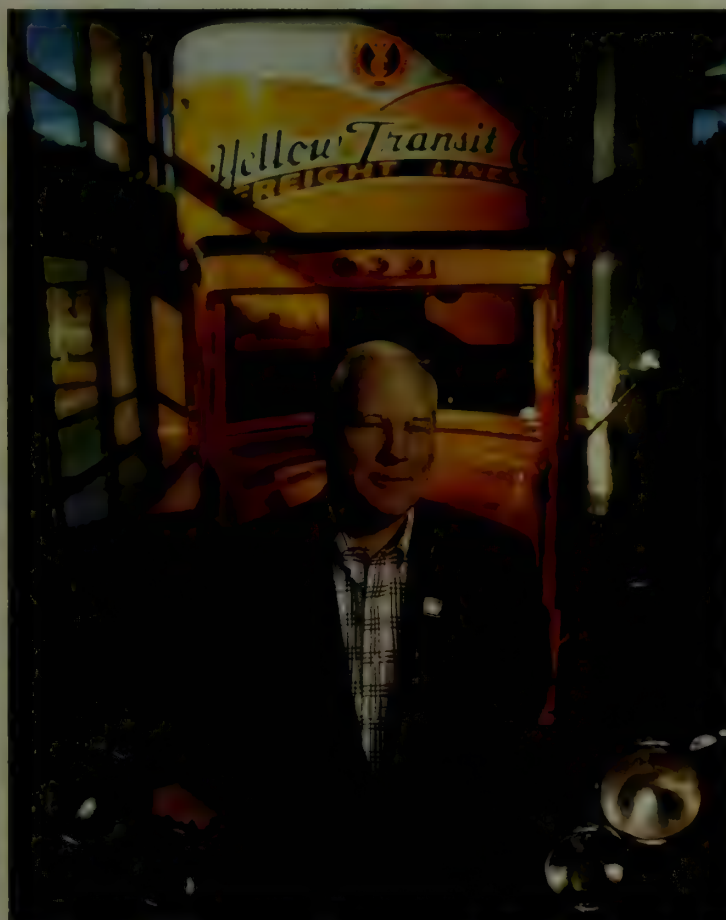
Zollars is betting that bringing the two shippers under one roof will not only save money but also create new revenue possibilities. He says Yellow already has pinpointed at least \$45 million in cost cuts. Zollars, says the 55-year-old industry veteran, Yellow has a bigger to compete. With highly paid Teamsters drivers it has been losing business to nonunion truckers. At the same time, FedEx Corp. and United Parcel Service Inc. have been grabbing sales as they take on bigger shipments. Zollars recently spoke about his strategy with *BusinessWeek* Senior Correspondent Michael Arndt.

Why does it show that most acquisitions don't pay off for the buyer. Why will this be different? Most of those poor results in the past have come from combining together two companies and trying to take out too much cost as fast as possible. We're not going to do that. We're going to continue to run each of these companies separately. The reality here is that we've got two companies with

tremendous brand equity that have hundreds of thousands of loyal customers today, with very little customer overlap. It just makes a lot of sense to keep both of those brands in the marketplace and continue to invest in both of those brands.

Then how do you make this deal pay off?

To make the deal add to earnings, we need only about \$30 million in savings. We think we can take out \$45 million to \$125 million in costs in the first year just in back-office functions such as payroll, credit and collections, workers' compensation, and legal.



“We’re going to continue to run each of these companies separately...and continue to invest in both of those brands”

—WILLIAM ZOLLARS

Then there are other operating synergies that really don't disrupt customer service. For example, we can combine purchasing of new trucks and trailers [for Yellow and Roadway]. Or, for another example, consider that today in Mexico, we each use separate partners to pick and deliver shipments. We could combine the volume there and eliminate one of the partners.

Isn't there a risk that your two subsidiaries will end up competing against one another?

Sure, but other industries have dual-branding strategies, too. There are reasons people buy a Pontiac instead of a Buick even though both are made by GM. We could come up with a strategy that focuses one brand on one set of customers and the other on another. It could be that one of the brands migrates more toward a high-technology, value-added brand. The other one might be more of a low-cost provider. Our mantra for the first year is going to be 'no change for the customer, no change to basic operations.' We want to keep our service levels up and stay focused on the customer so there's no reason for them to change.

What was wrong with continuing along the road you had been on?

Scale matters in our business. At the end of the day, you're going to have four or five major players in the ground-transportation business. We want to be sure that we're one of them. This deal makes us the No.3 ground-transportation provider in North America behind UPS and FedEx, and it puts us in a position where we're now the largest company in North America focused on bigger shipments.

What are you seeing in the economy?

Starting in June, we've seen signs of recovery. About 70% of Yellow's customer base is in the manufacturing sector. In July, our tonnage was up about 10% over last year. And for the first time ever, July tonnage was bigger than June's. The August blackout cost us about \$2 million in revenue. But all in all, that's just a blip. I don't think it's a significant impact on us or on the economy.



POWER

DID NUKES JUST GET A BOOST?

The industry sees opportunity in the wake of the blackout

At 4:13 p.m. on Aug. 14, Constellation Energy Group Inc.'s Nine Mile Point nuclear plant near Syracuse, N.Y., sensed voltage fluctuations on the grid. The plant automatically cut itself off from the rest of the nation's electrical system to prevent its power from frying nearby lines. Control rods lowered themselves into the two reactors to shut down the fission process. Within seconds, five diesel-powered backup generators were providing the power to circulate cold water around the reactors, cooling them down from their normal operating temperature of 540F. The reactors stayed off for three days as staff ticked through safety and operational checklists.

Depending on which people you talk to, the shutdown at Nine Mile Point was a triumph of nuclear power's safety and reliability—or the complete opposite. And in the wake of the Great Blackout of 2003, the disagreement between the pro- and antinuke lobbies is about to heat up. With Congress scrambling to resurrect the long-delayed energy bill, the nuclear industry is trying

to take advantage of the night the lights went out to build support for more plants. The bill may even include financial incentives to build new reactors. "Ensuring the proper level of power to the country demands that we make trade-offs, including production and greater use of such sources as nuclear energy," Senator Pete V. Domenici (R-N.M.), chairman of the powerful Senate Energy & Natural Resources Committee, said after the blackouts.

Once the pariah of the power business, nuclear power generation has been quietly growing since Three Mile Island nearly melted down in 1979. Thanks to improved equipment and better planning, the average nuclear plant now generates 91% of its total theoretical annual output, up from 62% two decades ago. So even though no new nuclear plants have come online since 1996, they keep cranking out more juice. Today, nukes generate one-fifth of all power in the U.S., up from 11% in 1980. Mindful that 40% of the licenses to operate nuclear plants were set to expire by 2015, the Nuclear Regulatory Commission in the past three years has granted 20-year license extensions to 16 of the nation's 103 reactors. A further 14 have filed for renewal, and 21 more are pre-

dicted to file over the next six

Now, proponents of nuclear power hope to use the blackout to extend the industry's renaissance. Industry lobbyists are expected to argue that although nuclear plants put less stress on the electrical grid than natural-gas-fired facilities, which are frequently turned on and off to take advantage of differences in fuel prices and to meet variable demand. Domenici is keen to provide the industry with federally backed loan guarantees and power-purchase contracts that could pay half of the construction costs for up to seven new nuclear plants. That would be a considerable boon to the industry. Congressional Budget Office estimates that a new 1,100-megawatt nuclear facility would cost up to \$2.5 billion, more than four times the cost per megawatt of a new natural gas facility.

Critics of nuclear power argue that it's absurd to spend so much on technology that is vulnerable to accidents and terrorist attacks. They also say that the nation's electrical reliability would be better served through conservation and building smaller, more distributed power sources—such as natural-gas-fired microturbines, wind, solar and hydrogen fuel cells—that can operate even if the grid goes down. "Nuclear is just a lousy technology," says Arjun Makharia, president of the Institute for Energy and Environmental Research, a green tank. Not least of all, Domenici faces opposition from fellow Republicans who are against any kind of federal subsidy.

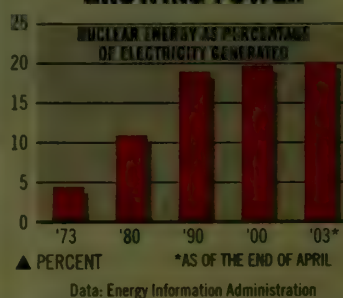
Will the nuclear power industry emerge from the blackout as a

stronger force? It's a toss-up. In June, the Senate narrowly voted to maintain nuclear subsidies in their current position of the energy bill. After years of dragging, Congress is now under pressure to pass some new energy policy. And even if the bill doesn't include goodies for the nuclear industry, it's likely that regulators will continue to extend reactors' operating licenses. Whether good or for ill, America will continue to be reliant on nuclear power for decades to come.

By Christopher Palmeri in Los Angeles with John C. in Washington



GROWING POWER



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THE MYTH OF INDEPENDENCE

Unbiased research? It's more elusive than you think

COMMENTARY

By Marcia Vickers

To say that Laura Weil, the chief financial officer of American Eagle Outfitters Inc., was apoplectic early last year is an understatement. She had just reviewed a report on her company from an independent stock research firm, the Center for Financial Research & Analysis (CFRA), which usually gets high marks for its work. She found no less than 10 factual errors, some serious. The report wrongly gave earnings and revenue numbers in billions rather than millions. It had the wrong dates for American Eagle's fiscal year. And it reported higher debt than the company actually owed. What's more, the report said that many easily found numbers from 10Q reports filed with the Securities & Exchange Commission as well as the company's annual report were "not available." Says Weil: "It was like they had a high school kid doing the report."

Weil complained and CFRA, which is run by Howard M. Schilit, a respected accounting expert, ultimately corrected much of the report. It may have been a one-time event for CFRA. But, Schilit says, "It's never an excuse when something's not 100% correct, but there can be human error in anything." He notes that the analyst didn't usually cover retail and that he, along with his supervisor, "are no longer with CFRA."

Regulators and investors are making an enormous bet that independent research—supposedly untainted because it has no links to investment banking—is the cure-all for a conflict-of-interest-riddled Wall Street. But it's not. Independent research, too, can have problems and conflicts of its own. Shoddiness is just one of them. Independent analysts' pay is sometimes linked to the amount of trading commissions they generate for their firms, much in the same way Wall Street analysts' compensation often depended on how much banking business they brought in. And with new research shops hanging out shingles every day, there are questions about their lack of track record and expertise.

For at least the next five years, independent research will loom large on

INDIE RESEARCH ISN'T A CURE-ALL

With the explosion in independent research startups, many seem hastily conceived and some fly-by-night

- ▶ Many hire analysts with little or no track record, raising questions about the quality of their research
- ▶ Some base their analysts' pay solely on how much trading volume their reports generate
- ▶ Others sell their reports to hedge funds and other pros who trade off the information well before it's available to the public

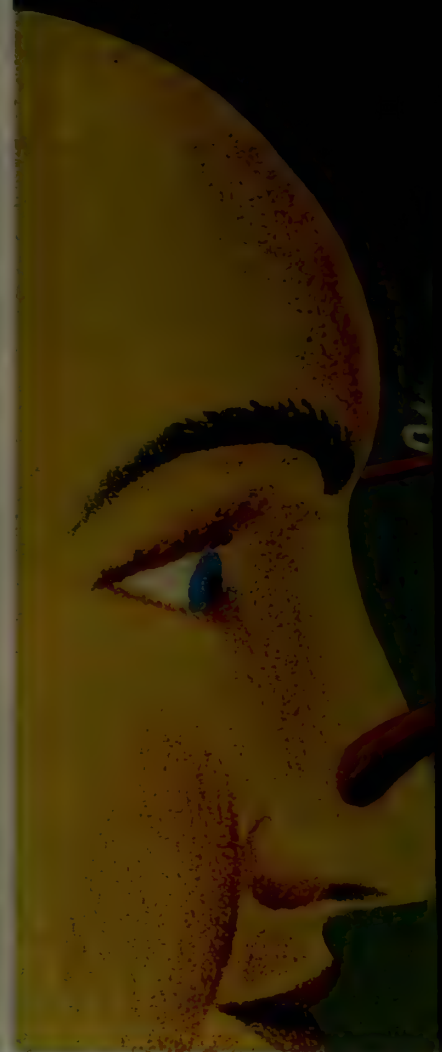
Data: BusinessWeek

Wall Street. During that period, 10 big investment banks, including Merrill Lynch & Co. and Salomon Smith Barney, must shell out around \$430 million among them to buy the stuff as part of their April settlement with New York Attorney General Eliot Spitzer and the SEC over tainted research. They must make the outside research available to clients along with their own. Independent consultants will decide which researchers to employ.

The instinct behind the settlement was sound. Good independent stock research can add value to stockpicking. Value Line, Morningstar, and Standard & Poor's (like *Business-*

Week, part of The McGraw-Hill Companies), among others, are widely recognized for their probity, accuracy, and credibility. Other reputable outfits jumping on the gravy train. Both Thomson Financial and Reuters Group, which now owns Multex Inc., an earnings searcher that offers indie analysis, recently announced they would sell stock research.

But all is not what it seems throughout the world of independents. Some of the biggest indies are not quite as attached as they might appear. Even the respected Sanford C. Bernstein Co. is owned by Alliance Capital Management, which runs numerous mutual funds and institutional money. Prudential Financial Inc., meanwhile, which entered investment banking late in 2000, is also a big mutual-fund player. New outfits can also face potential conflicts of interest, or at least be short on qualifications. For one thing, analysts at upstart small firms can be astonishingly inexperienced. Often fresh out of school, they take low-paying jobs at small independent firms to learn the ropes. "That's





to question the credibility of their research," says Charles L. Hill, Thomson First Call's director of research. Often, the more trading commissions analysts generate for their firms' broker/dealer arms, the more bacon they bring home. Soleil Securities Corp., an independent research firm started late last year by Wit Capital founder and former entrepreneur Andy Klein, is using analysts' compensation on how much trading volume and commissions they generate. Critics say this type of incentive potentially encourages analysts to make overly bold statements about a company, or report unsubstantiated rumors, to gin up business. What's more, analysts who aim their research primarily at traders are still inclined to issue more "buys" than "sells." It's because only those who already own the stock—a limited audience—will

be apt to sell, while there's a far bigger universe of potential buyers. And buys outnumber shares sold short even in this choppy market, by more than 30 to 1 on average. An Aug. 6 study for *BusinessWeek* by Thomson/First Call, the earnings research firm, shows that most Wall Street investment banks are issuing far more "sell" ratings—from 15% to 25% of their total ratings—than large independent researchers—10% or less. Says Soleil's Klein: "There may be lots of games [analysts] could play to get a quick break here or there. But researchers are going to go out of business if they don't help their portfolio managers make money over time, and that's our goal."

Stale or recycled research can be a problem, too. Like the Wall Street investment banks that give the first call on research to big trading clients, many

indie firms sell their reports to hedge funds and other institutions first. That's fine. But after the smart money has traded off the information, the report—or at least the "buy" or "sell" recommendation—is often then released to the public, by which time it has little value. "[The Wall Street settlement] is creating a short-term market distortion where independent researchers can profit and where investors still don't matter," says Scott C. Cleland, CEO of the Precursor Group, a Washington-based independent research firm.

Critics fear that when they pick outside researchers as part of the settlement, Wall Street investment banks will tend to favor those who are more bullish on stocks and less harsh on investment banking clients. And that's despite the "independent consultant" who's supposed to do the picking. "Their funding will be indirectly dependent on fees generated from IPOs [initial public offerings] and other stock offerings by investment banks," says James M. Sheehan, an adjunct scholar at the Competitive Enterprise Institute, a free-market think tank in Washington.

In addition to startups, existing indie firms are looking to cash in on the fast-growing market for untainted research. Steadily trying to gain market share, they are issuing more frequent reports on more companies, say critics. Schilit's CFRA is adding to the number of companies it covers, say critics. Sidoti & Co., a respected small-cap researcher, now covers 300, vs. about 100 two years ago, and says by the end of 2004, it expects to cover 600. Are they sacrificing quality for quantity? No, insists Schilit. "If anything, our ability to uncover accounting problems has improved dramatically in the past few years because of the enhanced tools and screens we use," he says.

Perhaps. But investors shouldn't be lulled into thinking that independent research is the holy grail for stockpicking. Some academics who study financial markets question whether stock research has much value at all, given the amount of information bouncing around the markets. Untainted research is obviously preferable to the flawed kind, but it's no silver bullet.

Senior Writer Vickers covers markets and investments.

Inexperienced analysts, stale or recycled research, questionable recommendations—the pitfalls are many

BONDS

THE LATEST MAGIC IN CORPORATE FINANCE

How contingent convertible bonds blindside shareholders

When biotech company Cephalon Inc. wanted to raise money and refinance old debt in June, it thumbed its nose at this year's low rates. In fact, it didn't want to pay any interest at all on its new bonds. And thanks to an accounting loophole, it was able to fashion a 0%, \$750 million offering of so-called contingent convertible bonds that investors snapped up.

Dubbed co-cos for short, such bonds are the latest craze in corporate finance. This year more than 100 companies, including Converse Technology and advertising-agency holding company Omnicom Group, have sold them in various forms. In June, General Motors sold the largest one yet, placing some \$4.3 billion in bonds paying 6.25% to bolster its underfunded pension plan. At the time, standard GM debt was yielding about 8.5%. As with Cephalon, Omnicom is paying no interest after raising \$600 million in June.

Raising money by selling bonds at little or no apparent cost is great for corporate bottom lines, but not so great for unsuspecting shareholders. The bonds carry below-market interest rates because investors, typically hedge funds, get a conversion option—the right to swap their bonds for stock—instead of interest payments. And, just as with the stock options granted to employees, companies don't need to treat the conversion options as an expense under generally accepted accounting principles (GAAP).

Even more critical for investors, companies—when counting their outstanding shares—don't have to include the shares that would be issued if the bonds were converted to stock. So shareholders can get hit with a nasty surprise. Accounting analysts at Bear, Stearns & Co. say companies issuing co-cos would see their earnings per share slip by an average of 6% if the con-



version options were included in the calculation.

For their part, the companies say they aren't hiding anything. Instead, they're doing the deals to get cheap capital, they say. Robert S. "Chip" Merritt, senior director of investor relations at Cephalon, says the company has been straight with the market. "Any professional investor would understand that this conversion could occur and would have modeled for it appropriately," he says. However, Christopher Senyek, an accountant at Bear Stearns who looked at more than 100 of the contingent con-

vertible issues, says public information on the deals is often "sketchy at best, making it hard to gauge their impact on stock prices.

Investors can blame clever investment bankers for this latest maneuver that stays one step ahead of the regulators. Merrill Lynch, Credit Suisse, First Boston, and Banc of America Securities are the kings of the co-co far. Tyco International Ltd. is believed to have issued the first co-co in 2000.

was underwritten by Merrill Lynch & Co. shortly after a proposed rule on convertibles from the Financial Accounting Standards Board on contingency convertible bonds. Companies issued about 120 co-cos in the last two years. This year's deals have mushroomed further, with 105 issued through July, according to Bear Stearns.

The advantage of co-cos is simple. With regular convertible bonds, companies must disclose the shares that might be issued when figuring their per-share earnings. But they can postpone the dilution

if they add another condition, or conditionality, to the standard conversion terms. For example, when CSFB underwrites a co-co, it usually allows a switch to stock only if the company's share price reaches 20% above the price used to figure how many shares will be given for each bond at conversion. In Cephalon's case, half of its bonds will be converted into stock at \$56.50, only when the stock, now at around \$67.80, trades above that level. If these bonds were regular convertibles, they could have been swapped for stock as soon as the price reached \$56.50.

Issuing a co-co rather than a regular convertible postpones the day of reckoning for Cephalon. But if its stock reaches the trigger level, the company's shares would suffer a sudden devaluation, clobbering its per-share earnings because bondholders could shift to shares. Bear Stearns estimates that this occurred next year, the hit could be 15%. Already, that has happened to some companies. Counting its shares for the first time in the second quarter, wireless outfit UTStarcom lost 11% off its per-share earnings.

So investment bankers have developed another product to deal with this problem.

HIDDEN COSTS

By adding extra conditions to traditional convertible bonds, companies can avoid revealing how much earnings would be diluted if the bonds were exchanged for stock.

Data: Bear, Stearns & Co.

	POTENTIAL DILUTION*
CEPHALON	15%
FEI	14
LATTICE SEMI	13
CONVERSE TECH	11
COMMONWEALTH TELE	10
GENERAL MOTORS	10
OMNICOM	10
MERCURY INTERACTIVE	10

*In estimated 2004 per share earnings

[ANOTHER REASON PSEG HAS WALL STREET'S ATTENTION]

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businesses. And as our overall earnings record suggests, good

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lem—a hedge to offset the dilution. But the hedges are expensive. Cephalon, for example, paid CSFB some \$258 million for one that would pay the company in cash or shares and help maintain the earnings per share if its bonds are converted. But that's a huge slice of the \$750 million Cephalon raised by selling the bonds in the first place. So at the same time, CSFB agreed to return \$178 million if Cephalon would take back some of the risk. The result: Cephalon bears the risk for conversions above \$72.08, instead of from the \$56.50 conversion price.

There's method to this apparent I-pay-you, you-pay-me madness. Cephalon

counts the \$258 million as an expense against its taxable income. Figured at the maximum 35% corporate tax rate, the result is a \$90 million tax saving, enough to cover the \$80 million difference between what Cephalon paid CSFB and what it got back. Cephalon says the \$178 million it retrieved from CSFB doesn't affect its taxes because the government doesn't tax gains from dealings in a company's own stock.

Meanwhile, FASB is playing catch-up.

If the past is any guide, companies will quickly find a loophole in any new rules

It has toyed with options issue since at least 1990 and now propose a rule by the end of the year would close the company exception counting the share behind a convertible. If the past is any guide, the bankers will

found the next loophole before the rule takes effect, leaving investors another variation of the by-now familiar riddle: How much did my company really earn?

By David Henry in New

BONDS

EUROPEAN JUNK REGAINS ITS LUSTER

With scandals fading, the high-yield bond market is booming

Dead in the water. That about summed up the state of the European high-yield bond market last year. Issuance of "junk" bonds slowed to a trickle. After edging higher as 2002 began, prices fell 12% last May through October, according to the Goldman Sachs High Yield Index. Moody's Investors Service downgraded 71 issues, compared with 56 the previous year. And defaults soared to a record \$45 billion in 2002, more than the total from 1985 to 2001. "There was a general feeling that when you invested in corporate debt, you didn't know what you were getting," recalls Gordon Wright, director at Standard & Poor's Investment Services in London.

Not so this year. Unlike in the U.S., where junk bonds are under pressure from a recent jump in Treasury yields, European high-yield debt is back with a vengeance. According to Credit Suisse First Boston, total junk-bond issuance in Europe as of July 30 hit \$8 billion, nearly triple the \$3 billion for all of 2002. By the time this year is through, bankers expect the figure to rise to \$12 billion, beating the \$10 billion record racked up in 1999. Behind the optimism: Corporate scandals are no longer in the headlines, and more companies want to restructure their balance sheets by stretching out the



EUROPE'S TOP JUNK BOND DEALS IN 2003

ISSUER	AMOUNT RAISED BILLIONS
VIVENDI UNIVERSAL	\$2.9
RHODIA	1.2
EIRCOM	1.2
HEIDELBERGCEMENT	0.8
CASE NEW HOLLAND	0.7
LEGRAND	0.7
FRESENIUS FINANCE	0.4

Data: Thomson Financial

maturity of debts, which relieves short-term pressure to pay.

Among the biggest players in the European market are the so-called fallen angels. These companies used to carry investment-grade ratings, but

were demoted after they became meshed in scandal or ran into management and cash-flow problems. By going to market, they hope to boost their balance sheets and eventually boost their ratings. In separate June and July bond floats, French conglomerate Vivendi Universal raised nearly \$3 billion to extend its debt maturity. Likewise, German manufacturer HeidelbergCement tapped the market for more than \$800 million in July. Such big names were willing to

the plunge has encouraged others eager to take advantage of historically low rates; coupons this year are averaging 9.35%, according to researcher Dealogic Ltd. Another factor is that some of the stigma has worn off. "In Europe, there's been this fear of the junk-bond bubble," says Tim Flynn, head of European high-yield capital markets at Goldman, Sachs & Co. "But companies are much less sensitive

The market has risen so far, so that some wonder whether it is setting itself up for a fall. Few investors, however, have been scared off. Indeed, the CSFB Western European High Yield Index had shot up 19% as of July, outperforming the major stock index in France, Britain, and Germany—to mention the U.S. That's broadened the type of money flowing in. Market players say there's even been some demand from U.S. institutions, although European investors of all stripes. Of course, an unexpected shock could shake the market. But bankers aren't worried, noting several large deals in the pipeline. The biggest: a \$1.4 billion issue by Italian yellow-pages company Seat Pagine Gialle, expected later this year or early 2004. The smart money seems to be saying: Don't bet against junk just yet.

By Laura Cohn in London

Clean, crush, macerate,
press, ferment, filter, age, bottle,
drink, and be merry.

There is much work to be done before
grapes can be transformed into fine wine.

Fortunately, Siemens integrated automation is in place to ensure that this age-old tradition operates with state-of-the-art efficiency. From making manufacturing more productive, to pioneering cleaner, more efficient energy technologies, to holding the world record for transmitting data over a single optical fiber, Siemens is reshaping and redefining entire industries. When you have 425,000 minds working together all around the globe, including 75,000 right here in the U.S., innovative solutions emerge. And that's what it takes to change the world.

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HOW TO GET U.S. BROADBAND UP TO SPEED

Providers and the feds must work together to stop the U.S. from falling further behind

COMMENTARY

By Roger O. Crockett

Broadband is on a tear in the U.S. For the 12 months ended in June, the number of speedy, always-on Internet connections has soared 43%, to 22 million users, according to market researcher RHK Inc. That's 18% of U.S. households. In four years, it could balloon to 50% of American households, estimates Forrester Research Inc. The service is surging "faster than any other consumer technology except DVDs," says Forrester analyst Jed Kolko.

Yet for all that progress, the U.S. is hardly the world's broadband leader. South Korea, Japan, and even Canada are ahead on just about every metric—from the percentage of their populations with broadband service to the speed of those services. Three-quarters of Korean households have it, and their broadband allows them to cruise the Net at 3 megabits per second, on average—about three times the speed American homes get. And the cost? About \$25 a month, compared with an average tab of \$45 for most Americans. In Japan, where 27% of homes have the service, broadband averages 10 megabits per second for only \$23 a month. "[Real broadband] has not even started in the United States," says Masayoshi Son, CEO of Japan's Softbank Corp., which is pushing the broadband rollout in Japan. Even Michael Price, senior managing partner at

the New York investment and advisory firm Evercore Partners Inc., says the U.S. "is on training wheels" when it comes to broadband.

But does it matter? Do broadband Net links have any impact beyond letting people swipe even more pirated music or while away the hours watching TV on their computers? Yes. For starters, broadband is critical to productivity. Through videoconferencing, it lets people work faster and more effi-

ciently from home, allows students take classes not offered at local schools and permits patients to get care from specialists over vast distances. According to a study by economists F. W. Crandall and Charles L. Jacks, the think tank Brookings Institute, universal broadband service could inject \$300 billion annually into the economy. Just as important, U.S. competitiveness is at stake. Intel, Microsoft and eBay became tech leaders, at

in part, because of experimentation in the U.S. with semiconductor software, and the Net entrepreneurs in other countries have a start of several years to test new broadband applications and business models, U.S. startups never catch up. "Technology leadership is not ordained," says Reed Hundt, the former chairman of the Federal Communications Commission.

That's not to say the U.S. can—and should—copy South Korea. Deploying broadband was fast and cheap because the country has 15 million households in only 38,000 square miles—1/100th the size of the U.S. And 60% of the population lives in apartment blocks rather than the sprawling suburbs where many Americans reside. And the Korean government invested \$850 million in broadband infrastructure and plans another \$850 million over the next four years. There is no appetite for massive federal investment in the U.S.

Still, America's tech



PRICE CUTS: SBC is pushing broadband with aggressive pricing

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LESS
AGGRAVATION**”

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band infrastructure could be improved with some elbow grease and a heightened sense of urgency. The first step is for the federal government to roll up its sleeves and get into the game. The U.S. is alone among developed countries in not having an official broadband policy. In 2000, the Canadian government set the goal of making broadband available in every community by 2005 and offered financial incentives for providing service in the remote Yukon. That helped push broadband adoption to 36% of all Canadian households, twice as high as in the U.S., says analyst Kathie Hackler of researcher Gartner Inc. All the U.S. has is the FCC, "which is dazed and confused," says Hackler.

A good start for any broadband policy would be for the FCC to clear up contradictions in its own regulations—and quickly. After an initial ruling on broadband regs in February, it took the FCC six months to write the roughly 600-page final draft. And the job is only half-finished. While the agency is phasing out old rules that forced regional telephone companies to sell digital subscriber lines (DSL), their broadband service, to rivals at state-mandated discounts, the Bells still operate under regulatory restrictions that obligate them to wholesale their DSL lines to rivals. Meanwhile, cable companies operate without these restrictions. That's a big reason why cable modem service is available to 85% of the country, compared with about 70% for DSL. The FCC is reviewing these DSL rules and could vote on them this fall. To boost the roll-out of DSL, the FCC should vote to eliminate them.

That's not all the government can do. Some 15% of the U.S. still doesn't have the opportunity to buy broadband service because it's too expensive to deploy in remote areas. The Broadband Internet Access Act, an initiative introduced by Representatives Phil English (R-Pa.) and Robert T. Matsui (D-Calif.) that is similar to Canada's Yukon effort, could help bridge the divide. That bill would give tax credits of up to 20% to companies that invest in speedy service in rural and other underserved regions.

Certainly, bringing U.S. broadband usage up to snuff is more about private enterprise than government initiative. The cable-TV companies and the Bells could spur consumer demand by lowering prices. Korea and Japan have such

BOOSTING BROADBAND

Broadband is faster, cheaper, and more popular in Korea, Japan, and Canada. Here's how the U.S. can catch up:

GOVERNMENT

REMOVE ROADBLOCKS Federal regulations still require the Bells to get government approval for many new services, such as DSL. Regulators should drop that rule, putting phone companies on the same footing as cable-TV operators. At the state and local level, government must make it easier for companies to obtain permits for network construction.

CREATE TAX INCENTIVES Congress should approve a bill that would give companies a tax credit worth up to 20% of their broadband investments. That would make it easier for phone companies and cable companies to deploy cable modems and DSL in the 15% of the country where it's currently too expensive to build.

SERVICE PROVIDERS

REDUCE PRICES At around \$45 a month, broadband is about twice as expensive in the U.S. as it is in Japan and Korea. To approach the popularity of broadband in those countries, American phone and cable companies will have to drop their prices.

BOOST SPEED For less than \$25 a month, residential customers in Japan connect to the Net at an average of 10 megabits a second—10 times as fast as the typical broadband connection in the U.S. American operators should adopt speedier technology, which is readily available.

CONTENT DEVELOPERS

FUND STARTUPS Venture capitalists should get off sidelines and start financing more broadband content startups such as Movielink, which allows consumers to view a limited number of films over their high-speed Internet connection.

PROMOTE FILE-SHARING To encourage people to use broadband, a much wider selection of music, video, and games must be available online. The music industry has made some progress in ironing out

the licensing and financial issues—even The Rolling Stones have made the jump to the Net. Now, the movie industry needs to figure out a way to distribute more of its wares over the Web.

Data: RHK Inc., company reports

high penetration rates in part because broadband is \$25 a month or less. Verizon Communications and SBC Communications Inc. are showing the way by dropping the price of DSL to \$29.95, in some cases with a package of phone services. They're betting they can make up for thinner margins with more customers—and emerge as the nation's broadband leaders. Other companies should follow their lead.

U.S. broadband providers also have to play catch-up on transmission speed. Kim Ji Su, a 23-year-old medical student in South Korea, boasts a 20-megabits-per-second Net connection that lets him play games, surf the Web, and watch reruns of popular soap operas—all at the same time. That sort of setup is pure fantasy for U.S. Web surfers.

Yet the technology is available to speeds both on cable and phone lines. An encouraging sign, Comcast Corp. is testing a 3-megabit service in Atlanta, Pittsburgh, and Knoxville, Tenn. If tests are successful, the service could become the standard cable-modem package. "We're bullish about this business and recognize the customers' need for more speed," says Greg Butz, senior vice-president for marketing and business development at Comcast Online.

The final piece of the puzzle is content. Relatively few U.S. consumers will buy broadband simply because of fast. They need compelling applications. One of the most promising, the ability to download and swap music, video, and other forms of entertainment, has been bogged down by legal controversy.





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questions about whether people will pay for digital music. Yet the emergence of legit, fee-based file-sharing services such as iTunes shows that those roadblocks can be overcome. "Much of the law necessary to establish property rights for content providers already exists," says Alan Fisch, an intellectual-property law expert at Howrey Simon Arnold & White, in Washington, D.C.

Still, there's a shortage of newcomers pushing Web content that takes unique advantage of broadband. Venture capitalists have cut their investments in startups precipitously, and Net-content providers have been particularly hard-hit. Just nine such startups received venture funding in the first half of the year, while 38 business-software companies did, says researcher Venture

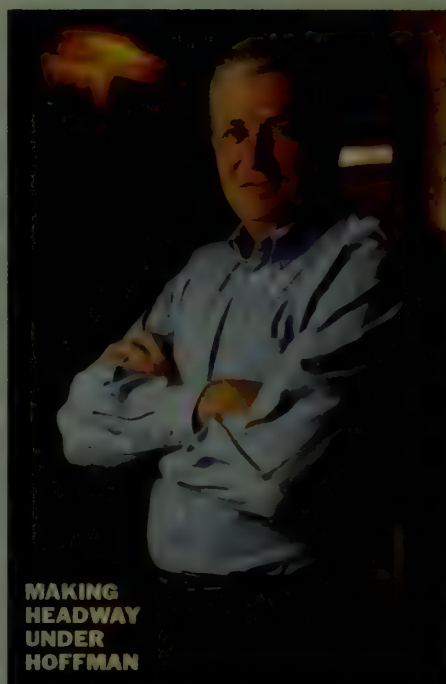
One Corp. It's time for Silicon Valley and Hollywood to work together to prove online offerings—following the steps of artists such as The Rolling Stones, who agreed to sell more of their music over the Web in August. Once that happens, U.S. broadband will really rock.

With Moon Ihlwan in Korea and Catherine Yang in Washington

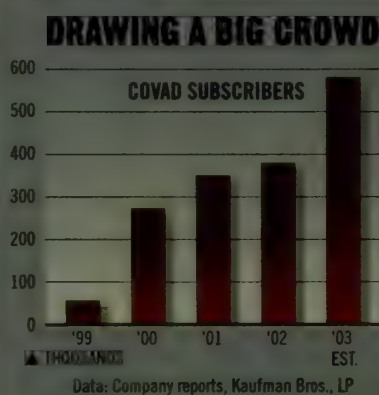
COVAD COMES BACK FROM THE DEAD

Just a few months ago, Covad Communications Group Inc. looked like one more Internet flameout. After building the largest network in the country for offering speedy Net access over digital subscriber lines (DSL), the company got hammered by the dot-com bust. In 2001, a third of its customers stopped paying their bills, and Covad was delisted from NASDAQ for not being able to close its books properly. The coup de grâce came in February, when the Federal Communications Commission said that, as a general policy, the local phone giants would no longer have to lease their phone lines to broadband rivals such as Covad at low wholesale prices. With its business plan in tatters, the stock, which topped \$60 in 2000, fell below \$1. Says CEO Charles E. Hoffman: "It was kind of like they moved the goalpost in the middle of the game."

Then it got moved back. In a surprise decision on Aug. 21, the FCC issued the final details for the broadband deregulation plans announced in February and put Covad back on solid footing. The commission grandfathered Covad in under the old rules—so the phone giants would still have to offer the Santa Clara (Calif.) company wholesale rates for its existing customers. That will give Covad time to execute a new strategy: teaming up with long-distance carriers to offer Net and basic phone services together. *BusinessWeek* has learned that Covad is close to finalizing a deal with MCI to market Covad's broadband Net access jointly with MCI's local and long-distance phone service. This follows a similar deal Covad has with AT&T, which has been offering a voice and Internet access package in New York since July and plans to expand to 12 more states by yearend. MCI declined to comment.



MAKING HEADWAY UNDER HOFFMAN



Hoffman is carving out a niche as a natural ally for the long-distance carriers. AT&T, MCI, and others need to offer broadband access to compete with the voice and data bundles being sold by regional Bell carriers and cable companies. Covad, which spent \$2 billion to build a cutting-edge network that reaches 96 top U.S. markets and a sophisticated billing system, can offer the long-distance

players rock-bottom wholesale rates because of some smart moves and tough cost-cutting. It wiped out most of its debt in bankruptcy, it laid off nearly 75% of its workforce, and it dropped a pricey effort to establish its own consumer brand.

Investors like the strategy. Covad's stock has risen from \$1.01 in late 2001 to more than \$3. "Covad has become an arms merchant for the long-distance carriers to fight against the Bells," says analyst Vik Grover of investment boutique Kaufman Brothers, who thinks Covad could have more than 1 million Net-access lines by 2005, up from 381,000 in 2002.

Of course, Covad's success depends on a continuation of the battle. Some analysts think AT&T and MCI will one day be acquired by the Bells. If that happens, the local phone giants may use Covad's network to serve customers outside of their home territories, but the Bells likely would use their own networks to push DSL wherever possible. Meantime, Covad is offering its wholesale service to other voice carriers and corporations so they can market to their customers. A seven-month-old partnership with AOL Time Warner Inc. is Covad's fastest-growing account. Says analyst Scott Cleland, chief executive of investment research firm Precursor Group: "Covad is making the best of a bad situation."

That's becoming a Covad hallmark. Despite having laid off so many of its employees, Covad has boosted customer service and increased its sales to small companies, which bring in most of the profits. "Finally, the market is starting to pay attention," says Hoffman. And this time it's not too late to see another former Net star crash and burn.

By Peter Burrows in San Francisco and Mateo, California

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MEDICINE

SHOCK THERAPY LEAVES THE CUCKOO'S NEST

The treatment is gaining acceptance, but controversy lingers

Ann Renee Hansard's daily cocktail of depression and anxiety pills was losing its power to lift her spirits. Although spring was bursting out around her home in Thomasville, Ga., life seemed to grow darker and duller with each day. In May, the unemployed teacher decided she needed something more to help her appreciate life again. So Hansard, 41, headed to Emory Uni-

versity Hospital in Atlanta for a series of electric shocks to her brain. Compared with the 1970s and '80s, when ECT was generally frowned on, the procedure is "clearly accepted as an effective treatment, and in some cases, a life-saving treatment," says Dr. Paul S. Appelbaum, chair of the psychiatry department at the University of Massachusetts Medical School and president of the American Psychiatric Assn. (APA) for the year to May,

past decade. And many more respond only temporarily. So psychiatrists continue to search for alternatives. For its merits, ECT benefits appear to wane with time, too, requiring follow-up treatment. Among the other promising therapies under study are electromagnetic stimulation, which causes seizures without ECT, and vagus nerve stimulation, which involves implanting a device like a pacemaker to stimulate a nerve linked to the brain—and which has already been approved for treating epilepsy. "I think these can even replace ECT," says Dr. Richard D. Weiner, a professor of psychiatry and director of the ECT program at Duke University Medical Center—but that is still several years away.

Although firm case numbers are hard to come by, anecdotal evidence suggests ECT treatments are on the rise. McLean Hospital, a psychiatric center in



versity Hospital in Atlanta for a series of electric shocks to her brain.

Electroconvulsive therapy, once seen as a barbaric practice because it induces brain seizures and was sometimes used against the patient's will, has emerged from the dark ages. While its effects on the brain are still not fully understood and it doesn't help all who try it, ECT is once again a widely accepted treatment for cases of severe depression, some types of psychoses, and catatonia. But gone are the days when patients writhed and bucked on the treatment table as teams of doctors and nurses fought to hold them down after electricity coursed through their brains. Anesthesia and muscle relaxants have eliminated the kinds of convulsions that were gruesomely enacted by Jack Nicholson in *One Flew Over the Cuckoo's Nest*.

Instead, in today's hospitals and clinics, patients are more likely to wake up wondering whether they've even had

Now it's a widely accepted remedy for severe depression

DARK DAYS: ELECTROSHOCK IN 1955

2003. As a treatment for depression, ECT now has the imprimatur of the National Institute of Mental Health, the American Medical Assn., the U.S. Surgeon General, and the National Mental Health Assn., a patient-advocacy group, as well as the APA.

The fact that ECT is helping at least some patients in the short term is good news. But it also highlights the enduring challenges of treating depression by less drastic means. At least 20% of depressed patients don't respond to medication, says the NIMH, despite major advances in drug therapies during the

month, Mass., that's affiliated with Harvard Medical School, says it gives about 3,000 treatments a year to 300 patients up from about 1,800 for 180 patients in 1996. And some high-profile patients are helping to erase the stigma that dogged ECT. Kitty Dukakis, the wife of former Democratic Presidential candidate Michael S. Dukakis, said through a spokesperson that ECT has helped her overcome her depression. She's now written a book about her experiences.

Despite the progress in shock administration, ECT is not likely to become as common as medication for treating depression. For one, it's more complex and more dangerous to administer, requires full anesthesia and oxygen, and because its effect on the brain remains a mystery, even supporters like the editors at the *Journal of the American Medical Association* acknowledge that "producing convulsions with electricity" seems like a strange way to treat



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illness." Psychiatrists generally recommend ECT if medication fails or a patient needs help fast, or for elderly patients who can't tolerate multiple medications. "It's a second-line treatment, when people need a definitive response," says Dr. Michael Henry, director of ECT at McLean.

Still, controversy lingers around ECT. Some patient-advocacy groups say patients suffer severe memory loss—and they are backed by a report in the June 21 *British Medical Journal*. Researchers at London University's Institute of Psychiatry analyzed 18 earlier studies in which patients were asked how they fared with ECT. This report repudiated a claim by Britain's Royal College of Physicians that 80% of patients were satisfied with the treatment, and that memory loss was not "clinically important." It found that at least one-third of patients report significant memory loss after treatment.

Doctors acknowledge the impact on memory but say it's limited and usually temporary. And the potential benefits of ECT, they say, are significant. Patients tend to feel better almost immediately. Medication can take anywhere from 4 to 12 weeks to have an impact—and a

process of trial and error can stretch that out longer. Advocates also point to a study in the Mar. 8 issue of *The Lancet* deeming ECT an effective, short-term treatment for depression.

One of the challenges is to prevent relapses that seem to affect many patients. Some doctors recommend follow-up treatment with medication or a regimen of "maintenance" or occasional ECT, starting with once a week, but growing less frequent over a six-month period.

The treatment's history and shortcomings have not stopped thousands every year from seeking ECT—many as outpatients. At McLean, the procedure takes about 20 minutes, patients wake up from anesthesia shortly after, and they leave within an hour or two. The regimen generally calls for 6 to 12 "doses,"

BRAIN TEASER

Electroconvulsive therapy relieves the symptoms of depression—but nobody is sure why. Here are the three leading theories:

- ▶ May activate brain chemicals like serotonin and dopamine, which regulate emotion and mood
- ▶ Possibly stimulates the hypothalamus, a gland in the brain that releases hormones that affect mood
- ▶ Jolts may teach the brain to resist seizures, reducing abnormally energetic brain activity and stabilizing mood

exactly that question. Its spending research on major depression rose to \$206 million, between 2000 and 2002. Within a few years, doctors may have even stronger weapons in their depression-fighting arsenal.

By Faith Arner in Boston

administered every day. Each dose is about 30 jules of electricity, or enough to light a 100-watt light bulb for one second, says Dr. Clifford Coffey, chair of the department of psychiatry at the Henry Ford Health System in Detroit.

Hansard says she felt better after her treatments at Emory May. But she suffered more memory loss after a previous round in early 2001. She's considering maintenance ECT, but she would like to see more research on it. The NIMH is funding studies that add

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RESEARCH

A HOTHOUSE FOR BIOTECH

Once-humble UC San Francisco is an innovation machine

For Cynthia J. Kenyon, the secret to a long, healthy life is in the genes. That's what she concluded after 10 arduous years spent isolating and analyzing some of the 19,000 genes of a microscopic roundworm. The University of California, San Francisco biochemist announced in early July that a single gene known as *daf-2* dictates the behavior of other genes that control cellular-stress responses. When altered through a process of chemical mutation, that lone gene keeps the others functioning normally—helping the body resist the wear and tear of aging. The worm's lifespan doubles, and by all appearances, it is healthier than other worms half its age.

Dorian Gray, the worm, is just the beginning. Scientists elsewhere have duplicated Kenyon's results in fruit flies and mice, shedding light on some of the fundamental questions about why and how living things age. Because humans share many genes and much basic biochemistry with lesser animals, such work may provide clues to creating a fountain-of-youth pill or injection. And even if 50-year-olds don't end up looking like college kids, this line of inquiry could spawn novel treatments for heart disease, Huntington's disease, and certain cancers associated with aging.

Kenyon credits the school that has

backed her research. "There's a great amount of brains here," she says, "and the university provides the brawn." Indeed, if any team of researchers is positioned to crack the mysteries of aging, it's the UCSF network of students, staff, and alums. Once little more than a good regional medical institution, the agriculture-focused state school system UCSF has become a world-class success case for biomedical innovation. Its achievements and culture have attracted both faculty and funding on a scale other medical-research schools have been able to match.

The concentration of brainpower defies simple enumeration. Down one street is the lab of Stanley B. Prusiner, 1997 Nobel Prize winner who discovered prions, the infectious agents that cause mad cow disease. In an office across the street is J. Michael Bishop, who shared a 1989 Nobel Prize. UCSF alum and former faculty member Harold E. Varmus for the discovery of genes that cause normal cells to become cancerous. The faculty boasts 30 members of the prestigious National Academy of Sciences, and professors have been involved in upwards of 60 biotechnology spin-offs. These include industry pioneers Genentech, Chiron, Geron

which Johnson & Johnson ac-
this past April for \$2.4 billion.
off the campus, and the stew-
p of America's top scientific insti-
s seems to be in the hands of
graduates and former faculty. A
list includes Julie Gerberding, di-
of the Centers for Disease Con-
d Prevention; Bruce Alberts, head
National Academy of Sciences;
on General Richard Carmona—
of course, Varmus, who ran the
al Institutes of Health and is now
ent of the Memorial Sloan-Ket-
Cancer Center in New York.

UCSF medical mafia is just one
station of the institution's growing
ice. The university has an uncanny
to attract funds. For five years
g, it has outshone most other uni-
ies in numbers of NIH research
a. With a \$365 million tally last
it surpassed every school nation-
except Johns Hopkins University,
niversity of Pennsylvania, and the
rsity of Washington, exceeding ri-
uch as Harvard and Stanford in
graduate grants.

ivate donations, meanwhile, have
\$200 million every year since 1999.
past year alone, the Bill & Melinda
Foundation awarded \$28 million
research into AIDS prevention in
And Intel Corp. Chairman An-
S. Grove offered \$1.5 million in do-
s and \$5 million in matching grants
search in stem cells. UCSF is one of
w U.S. institutions pursuing work
se controversial cells, which are of-
arvested from embryos and can ma-
into any tissue of the body. "It's fit-
to use some of the money that came
the previous tech revolution to help
he next one," Grove says.

some regards, UCSF's academic
vement seems almost accidental.
e Stanford or Harvard—and not
ay particular plan—the institution
o undergraduate schools or athletic
ams that compete for funding. So
hy donors never have to listen to
than one fund-raising pitch. But
strategic thinking also helped turn
campus into a research
house. Starting in 1968,
administrators devised radical,
orative approaches to reh-
h, and these methods
ly attracted some of the
test minds.

at's not to say that UCSF
ines other distinguished
rch centers
as Har-
Yale, or
Hopkins.

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UCSF'S ROAD TO GLORY

1873 University of California Medical Dept. founded in San Francisco.

1947 University of California becomes important test center for experimental treatments of terminally ill cancer patients.

1953 Stanford Medical School's decision to move from San Francisco to Palo Alto leads to many doctors and scientists eventually making the switch to UCSF.

1969 Gene pioneer Bill Rutter arrives as head of UCSF's biochemistry department and creates intense collaborative atmosphere. (Thirteen years later, he founds biotech star Chiron.)

1976 J. Michael Bishop and Harold Varmus discover cancer genes. Same year, UCSF scientist founds Genentech, kicking off Bay Area's biotech industry.

1989 Bishop (right) and Varmus win Nobel Prize for work on cancer genes. Meanwhile, collaborative research efforts attract increasing federal funding and private donations. UCSF becomes known for pioneering AIDS research.



1996 City of San Francisco and Catellus Corp. donate 43 acres of land to expand space-starved UCSF campus. Mission Bay campus, when completed in 2020, will double space for UCSF research and classes.

2003 UCSF boasts more than two dozen members of National Academy of Sciences among faculty and one of the heftiest research coffers in the country.

"The Eastern institutions are doing just fine," says Varmus. Nevertheless, notes alum Marv Cassman, former head of General Medical Science at the NIH: "There are just a few institutions in the country that compete for top talent, and UCSF is one of them."

For the research staff at UCSF, the monumental goal is to churn out a scientific discovery a week across a variety of fields and disciplines. Administrators believe that will require a major upgrade of the physical environment. The institution is in the first phase of a 15-year, \$1.5 billion building boom, the largest university expansion in the country. A 43-acre second campus called Mission Bay is rising south of downtown San Francisco, replacing old rail yards and abandoned warehouses with state-of-the-art research facilities. Here, scientists will combine physical science and biology with intense computational research to study some of the most complex biological processes—such as how the body's genes, hundreds of thousands of proteins, and chemical signals interact with one another and with pathogens in the genesis of disease.

This work could lead to new drug-development strategies as well as insights on disease management and prevention.

For most of its history, UCSF seemed an unlikely place for creating radical change. As late as the 1960s, it was known mostly for competently providing clinical care to the public through San Francisco's general hospital. Fundamental research was little more than a dream. But the mission changed under the influence of Bill Rutter, who ran the department of biophysics and biochemistry. Hired in 1969 to head UCSF's modest chemistry department, Rutter institutionalized the practice of collaborative research on a grand scale. Eschewing the traditional department concept, Rutter believed the best way to encourage discovery was by grouping researchers who shared a common interest instead of lumping specialties together by department. These so-called neighborhoods might include chemists working side by side with mathematicians and biologists.

It was in Rutter's own lab that a hepatitis B viral gene was cloned and inserted into a bacterium, leading to the hepatitis B vaccine—the first recombinant human vaccine ever produced. "For more than three decades, the university has invested unflinchingly



ly in collaborative biomedical research," says David A. Kessler, former head of the Food & Drug Administration who in June was named UCSF's new dean of the School of Medicine.

The university's strength in genetic research has helped transform modern medicine. Scientist Herbert W. Boyer's 1973 work on techniques for altering DNA led directly to the synthesis of insulin, human growth hormones, and hemophilia medicine. The biotech revolution was under way, and Boyer went on to co-found Genentech Inc.

Three years later, Varmus and Bishop discovered that a gene that directs normal cell growth, if it mutates, can promote the uncontrolled growth of cancer. The discovery of these so-called oncogenes turned cancer research on its ear by establishing how the growth of cancerous cells can be triggered by exposure to a carcinogen, such as radiation or smoke. More than 100 oncogenes have since been identified, opening the door to a variety of cancer treatments aimed at activating or shutting them off at the right times. Bishop now serves as chancellor of UCSF, spearheading the Mission Bay expansion. "The reason we've been so successful is that there's open discussion and a totally unfettered exploration of the question 'what if?'" Bishop says.

The string of discoveries attracted powerful friends. Venture capitalists, many of them in the Bay Area, jumped at the chance to fund UCSF's

RADICAL Its highly collaborative approach to research has drawn some of the brightest minds to UCSF

many spin-offs. And when the landlocked university considered moving out of San Francisco in 1996 because researchers were working out of closets and reclaimed bathrooms, Gap Inc. Chairman Donald Fisher, investment banker Sanford Robertson, and the mayor's office struck a deal with the commercial developer that owned the 303-acre Mission Bay property to offer part of it—worth \$70 million—for free. "These are enormously important research facilities, and we wanted to do everything we could to keep them here," says Rudolf Nothenberg, former chief administrative officer for the city.

The university also doubles as an incubator for promising scientists. Senior

THE CDC TURNED TO DERISI FOR SARS HELP

faculty scour the world for young researchers, graduate students, and potential candidates

might thrive in this cross-disciplinary hothouse. "The place is crawling with people who could be off on their little ego adventures because that's that good, but they see the value in talking with each other," says Ken Yamamoto, chairman of the Cell and Molecular Pharmacology Dept.

The can-do attitude helps win converts. For instance, when the CDC was struggling to classify the SARS virus, it turned to a young UCSF scientist, DeRisi. Months earlier, DeRisi had printed samples of all 12,000 viral sequences known to science on a slide. Called a DNA microarray, it's based on the laws of nature, meaning that if a virus applied to the slide would gravitate toward a like virus. DeRisi and his research assistant took just 12 hours to use a PC and fluorescent microscope to confirm that SARS was closely related to a bird virus but merited a new classification all its own. Discovering the

virus, by contrast, took many months. "What we did obviously was that novel, and we did it really," DeRisi

UCSF's newest challenge is marrying such technology with more basic research. Genomics, proteomics, and other fields that explore the fundamental interaction of individual proteins—and even atoms—require intense utilization of databases and pattern-recognition tools. At the new Mission Bay campus, UCSF aims to address these exact problems. In fall, 2003, the school plans to open the Institute of Quantitative Biomedical Research, headed by Cassman. It will serve as a clearinghouse for expertise and resources at the intersection of genetics, physics, chemistry, and computer science. The goal is to create the medical equivalent of industry-standard technology tools that can be quickly disseminated elsewhere, helping speed the creation and delivery of new medical treatments. Researchers at UCSF would not have it any other way.

By Cliff Edwards
in San Francisco

MONEY MAGNET

UCSF ranks fourth in government research funding*

	MILLIONS
JOHNS HOPKINS UNIVERSITY	\$510
UNIVERSITY OF PENNSYLVANIA	418.5
UNIVERSITY OF WASHINGTON	405.7
UNIVERSITY OF CALIFORNIA, SAN FRANCISCO	365.4
WASHINGTON UNIVERSITY, ST. LOUIS	343.7

*Funding from National Institutes of Health

Data: NIH

BusinessWeek online

For further comments on the rise of UCSF, go to www.businessweek.com/magazine/ent

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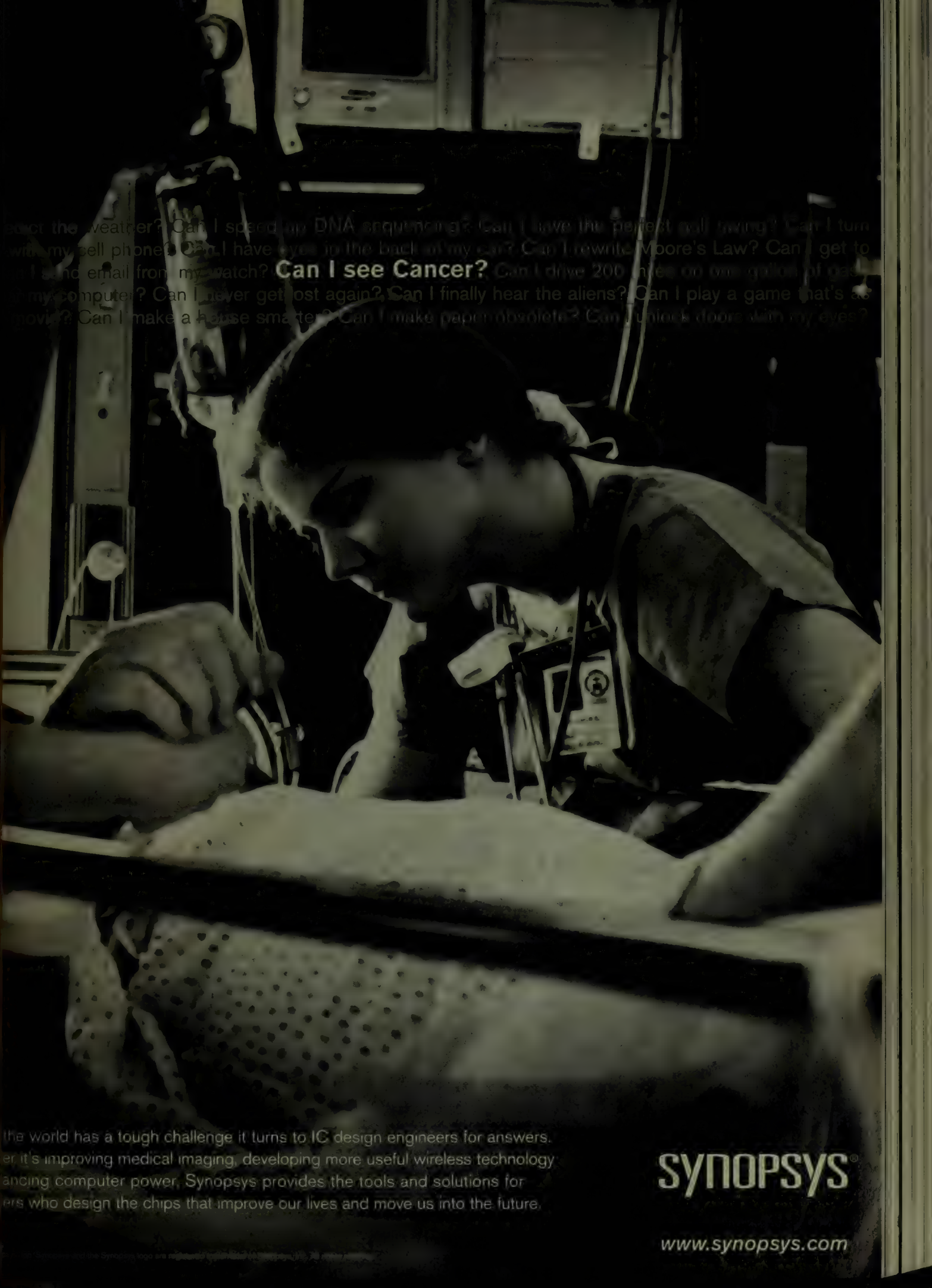
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Developments to Watch

BY ADAM ASTON

PHONES ER THE T-AND-SHOP ERA

S GADGET LOVERS LOOK for phones that take the digital pictures. But if frequency ID tags start popping up in clothing, accessories and household gear, as tech visionaries believe, consumers may demand phones that can read data on those RFIDs.

Consumers who aren't concerned about the loss of privacy, the proliferation of handheld readers will turn the random encounters of daily life into a world showroom," says Wang Wan, a senior researcher at Accenture Technology Labs in Chicago. Point your phone at a friend's



A CLICK AWAY: Find out any item's price, brand, and store

handbag, and it might display the brand, the store selling it, and the price. Hit one key, and you could browse the vendor's Web site—and with another thumbstroke, purchase the item. Your friend might even get a small modeling fee. Accenture has built

prototypes using personal digital assistants. And while privacy is a big concern today, Wan doubts such worries will derail or slow down the adoption of RFID very much. "New technology often looks intrusive in the beginning," he says. *Neil Gross*

FROM SEAWEED, A GEL TO REPEL AIDS

NEW WEAPON MAY BE ON the horizon in the fight against AIDS. And it has its place in an unlikely place—seaweed called carrageenan that has been used for decades in products such as ice cream, toothpaste, and soup. Carrageenan is the key ingredient in a gel called Carraguard now undergoing human tests to block transmission of HIV. How does it work? The gel has

a strong negative charge, which allows it to bind well to the positively charged AIDS virus, as well as to certain cells in the vagina and cervix. Applied before intercourse, the gel ends up effectively coating both these cells and the virus, preventing HIV or infected cells in the man's semen from adhering to cells in the vaginal wall. Carraguard is ideally suited for use in Third

World countries: It can withstand high temperatures and is relatively inexpensive to make. And it doesn't get absorbed into the bloodstream, where it might cause complications.

The Population Council, a nonprofit research group, is preparing for final clinical testing of the product. The trial, involving some 4,200 women in South Africa, should run about four years. *Amy Barrett*

IT HAS TLE MERCURY. WHAT?

OCEANS ARE AWASH WITH amounts of mercury. No problem for the fish and mammals that have evolved to tolerate it. But humans can't, a diet of mercury-tainted tuna, swordfish, or shark is often thought to be risky, especially for pregnant women. The Aug. 29 issue of

Science, however, researchers report that the chemical form of mercury occurring in big game fish may be less hazardous than previously thought. Mercury's toxicity depends on the chemical composition of the compound in which it occurs. Until recently, testing methods in fish flesh obscured certain details of the metal's molecular structure, leading scientists to assume it was a fairly toxic

form of mercury, says Graham N. George, a biophysicist at the University of Saskatchewan and a co-leader of the project. Using high-en-



BLUEFIN TUNA: Not so deadly after all

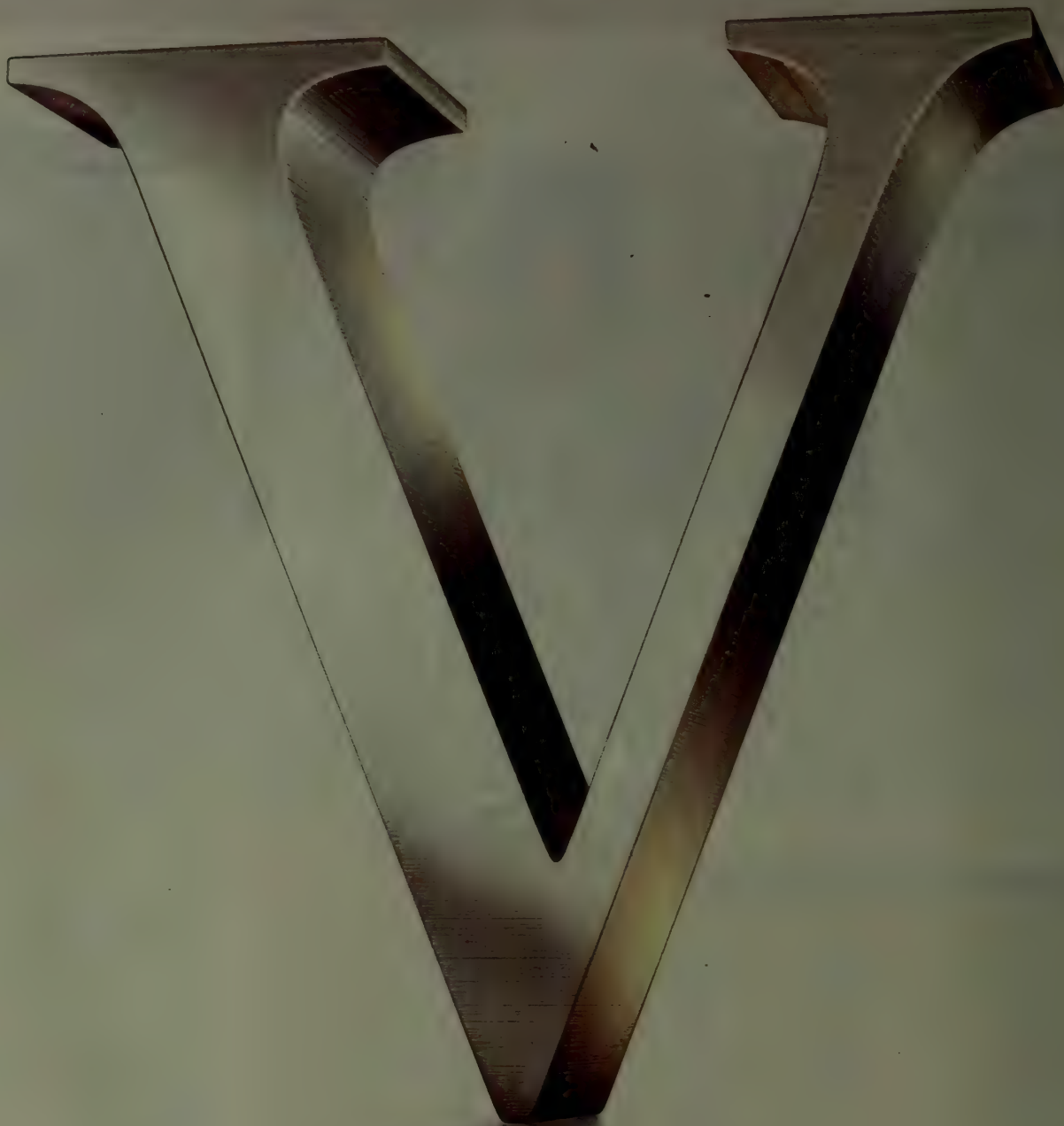
ergy X-rays to paint a finer picture of the fish-borne metal, George's team found that it is bound to a group of atoms that might make it less toxic to humans.

While more research is needed, the findings suggest that public health officials may be overestimating mercury's threat, says George. His team's ultimate goal is to improve treatments for mercury poisoning. ■

INNOVATIONS

■ Scientists have identified a chemical marker for Alzheimer's disease that could lead to more reliable diagnoses. Known by their acronym, ADDLs (pronounced "addles"), the telltale toxic protein clumps were found in the brains of Alzheimer's sufferers at concentrations up to 70 times higher than in normal people. The Northwestern University researchers believe ADDLs destroy memory function by lodging in the brain's neural synapses. The scientists hope to develop a blood test for ADDLs that could replace the psychological exams now used to diagnose Alzheimer's. The work, published online by the *Proceedings of the National Academy of Sciences*, also points the way to further research on how to counter the ADDLs and slow, or reverse, memory loss.

■ Athletes like creatine for its brawn-building benefits. Now it turns out this compound, which occurs naturally in humans, may also enhance memory. In a study at Australia's University of Sydney, a group of young adult vegetarians who received a daily five-gram dose of the supplement had a boost in working memory. The researchers did not determine the duration of this improvement or the long-term consequences of using creatine. The results appear in the Royal Society's *Proceedings B* journal.



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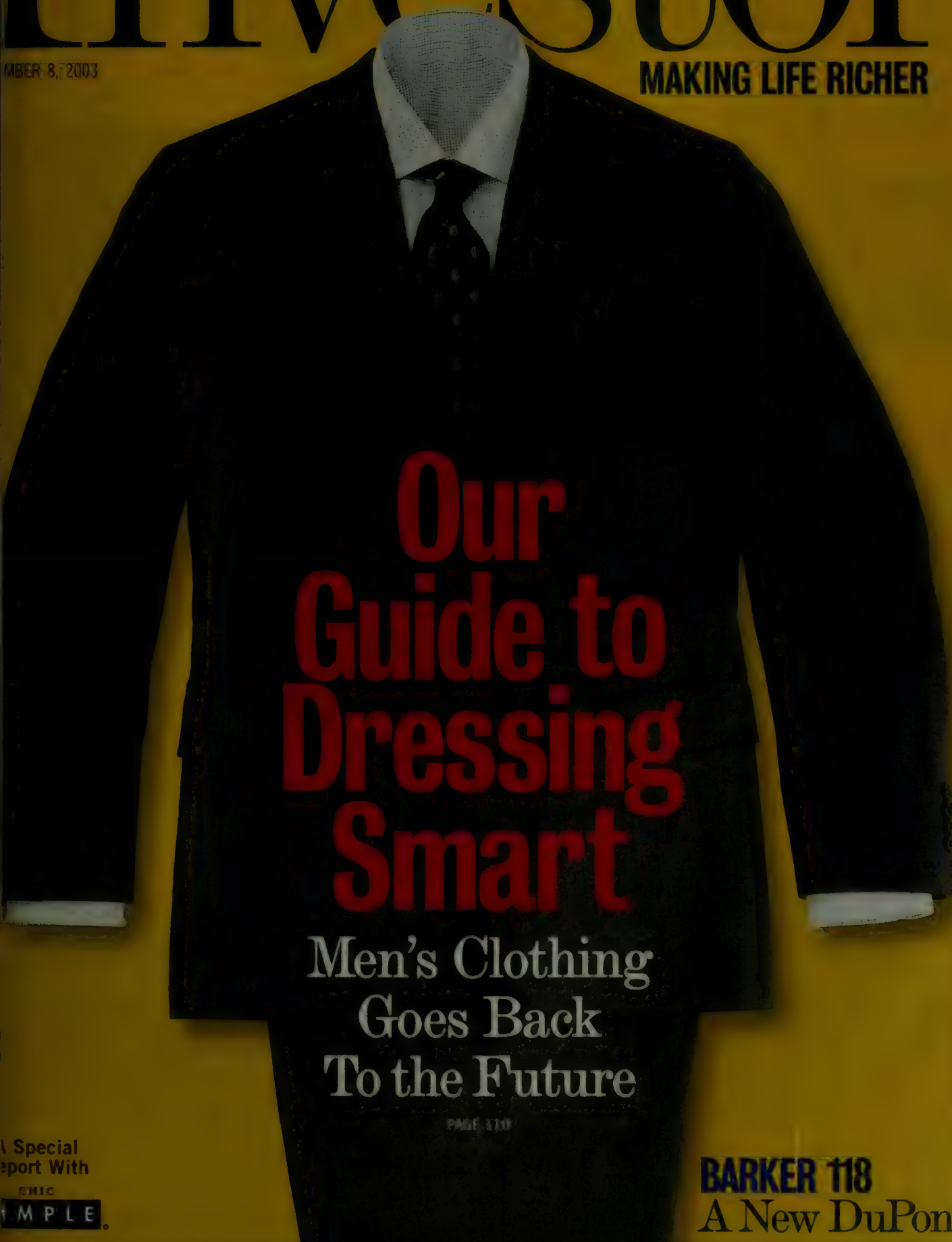
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BusinessWeek

Investor

NUMBER 8, 2003

MAKING LIFE RICHER



Our Guide to Dressing Smart

Men's Clothing
Goes Back
To the Future

PAGE 110

A Special
Report With

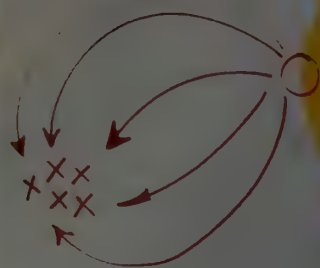
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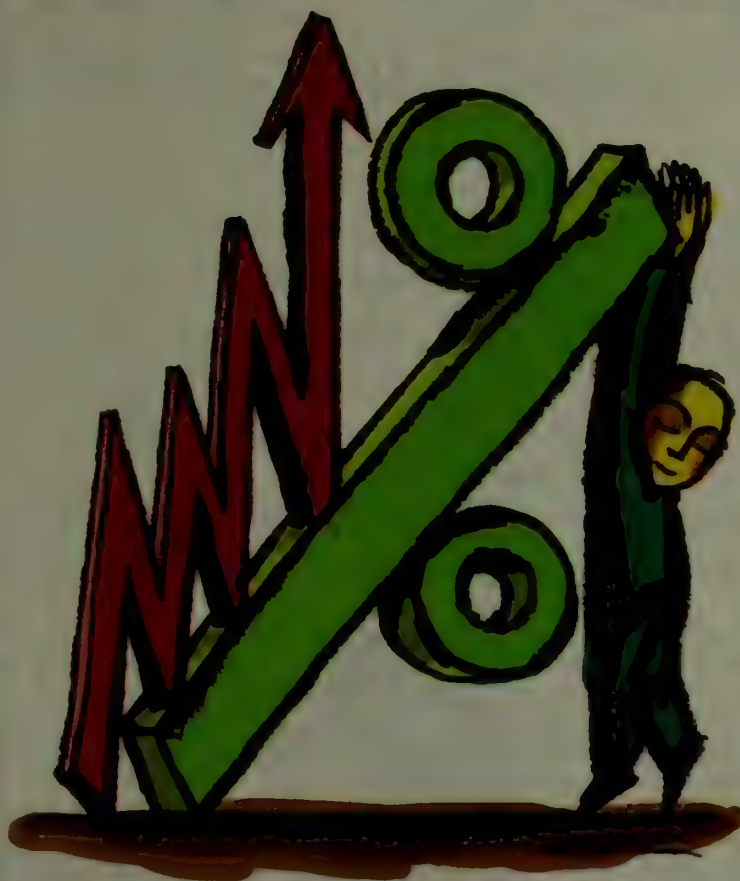
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ON. The amount of
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FRESH FROM FARMER



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ACCOUNTING

Pension Profits

IT MAY SOUND ODD, but companies making contribu-
tions to their underfunded pension plans will boost
their bottom lines. Why? "The magic of pension ac-
counting," says David Zion, accounting analyst at CSFB.

Instead of requiring companies to record what their
pension investments actually earn each year, accounting
rules allow bean counters to assume a **constant annual re-
turn**. This is permitted because relying on actual returns
would cause net income to jump around with stock prices.

As a result, when **General Motors** follows through on a re-
cently announced plan to shore up its pension fund by up to
\$13 billion, it will assume its U.S. pension fund will earn a
9% return on its contribution. The net impact to earnings
will be less than 9%, however, because GM borrowed the
money for its pension contribution at an average rate of 7%.
After taking a tax deduction on the interest on its debt, GM
should make a net earnings gain of about 4%. So if the car-
maker were to plow \$10 billion into its U.S. plan on Jan. 1,
its 2004 earnings would rise by about \$400 million. Talk
about turning lemons into lemonade.

Anne Tergesen

PHOTOGRAPHY

DISPOSABLE DIGITAL

Disposable
cameras
go digital
with **Ritz
Camera's
Dakota
Digital**



(\$11). There's no liquid
crystal display and no ability
to download shots to your
computer, but you can delete
the last shot if you think
you've blown it. You still have
to return it to a Ritz store—it
costs another \$11 for prints
and a photo CD—just like a
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TRAVEL

CAMP INTERNET

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DRESS SMART

THE NEW WARDROBE INTELLIGENCE

The latest trend in men's business dress is best summed up in a word coined by celebrated Ford Motor designer J Mays: retrofuturism. It involves taking classic design and updating it with modern technology. You see it on the 2003 Ford Thunderbird, revitalized with 21st century engineering creature comforts while remaining true to its 1955 styling. And you see it in men's suits, shirts, and ties that marry innovative fabrics and inspirations drawn from past eras of elegance.

The traditional single-breasted, gray suit, for instance, may now have lapels that are peaked rather than notched, and a more fitted jacket than the "sack" suit of yesterday.

Yet comfort is foremost, in part thanks to the technology used by Italian textile manufacturers to create the lightest-weight wools ever. Top Italian mills such as Loro Piana and Carlo Barbera have pioneered the development of these high-performance wools, known as "super 100s," with threads that measure just 18 microns (18 millionths of a meter). Super 120s measure 17.5 microns.

The fineness of the fibers, spun with a high degree of twist, gives the yarn a springy resilience. The resulting suit has tremendous body and drape without sacrificing shape or line. No more ultraheavy suits for winter. These fabrics are meant to be worn year-round. Discerning dressers who still want variation in their summer and winter wardrobes can use seasonal colors to draw the distinction. Much of the best new clothing bears the look and finesse of custom tailoring, yet is available off the rack at prices ranging from \$600 to more than \$3,000. The highest prices reflect the level of hand stitching and the quality of the fabrics.

Back to the Future

In keeping with the retrofuturist trend in tailored clothing, the best shirts and ties feature Old World design elements in updated colors and fabrics. Shirts are slightly trimmer in fit than you've grown accustomed to. Spread collars are back, thanks in part to the influence of such classic British shirt-makers as Thomas Pink opening shops across the U.S. Both the English spread and the more modified American version are formal and flattering. If you have a round face, though,



you may find you favor the modified version.

The fabrics will have surface interest—a color shirt in a micro-herringbone weave, for instance. And what you would have formerly thought of as sporty—tattersalls, gingham, and subtle plaids—now come in dressed-up versions. French cuffs make the difference, whether the shirt is solid or patterned. They are undeniably elegant and complement the new variety of spread collars.

COLORFUL

A collection of spiffy cuff links, including ones that make a playful reference to a sport, will help add flash to your look.

Plus, you can build a great link wardrobe. Precious-metal cuff links in gold or silver look best understated rather than large and shiny. For color, consider geometric patterns worked upon double-sided, ceramic ovals, or inexpensive, simple silk knots, perhaps in

contrasting colors. Or look for vintage links. A playful nod to a favorite sport acknowledges a time when men dressed up for the country.

In ties, classic patterns such as regimental stripes, understated geometrics, or even solids are worked in luxurious, textured silks, and in rich, sometimes unorthodox colors like purples and deep pinks. The typical width is still about 3½ inches, but high-end designers have been reshaping their neckwear to a fuller width throughout, which means the knot will be fuller, too—recalling the Edwardian era of 100 years ago.

For fall, you can go from classic casual to formal and still be suitably attired. You know what you like, and you also know what's appropriate for your company or industry. But to get you started, we've selected four suits to show the range, with shirts and ties to pull the outfits together.

CHIC

SIMPLE

HOW DO YOU PUT A NEW LOOK TOGETHER?

To get answers, *BusinessWeek* editors teamed up with the creators of Chic Simple, Kim Johnson Gross and Jeff Stone, who have written 25 lifestyle books, including *Dress Smart for Women* and *Dress Smart for Men*.

(LEFT TO RIGHT) VINTAGE CUFF LINKS, \$27.50; TINDER BUTTONS, SUIT, \$750; SHIRT, \$78.50; TIE, \$97.50; ALL JOSIE PH AUBOUD SUIT, \$1,295; SHIRT, \$115; TIE, \$90; ALL HICKEY FREEMAN SUIT, \$2,795; SHIRT, \$295; TIE, \$125; ALL OXFORD CLOTHES; SUIT, \$1,295; CORNELIANI USA; SHIRT, \$135; HICKEY FREEMAN; TIE, \$105; BEST OF CLASS BY ROBERT TALBOTT

The Classic Casual Suit

A popular with aristocrats for out-of-town week-ends, **THE COUNTRY SUIT IS BACK**. Traditional "farm" fabrics such as tweeds have been reengineered into surprisingly lightweight. Country suit terms such as glen plaid and Prince of Wales are still around, but the **NEW COLOR palette** is much more varied, woven with variations of the same color. Pairing a subtle plaid shirt with a geometric-patterned silk tie. As the colors are complementary, your "country" look will work.

The New Palette Suit

Charcoal gray is always correct, but it looks updated when traces of brown, olive, or taupe saturate the weave. Instead of standard white, **THE CLASSIC CHALK STRIPE IS REINTERPRETED** in shades of camel, burgundy, blue, or purple—a favorite accent color this fall. Chalk stripes are used for a dressy effect, but we opted for a colorful gingham mini-check shirt to provide an artful counterpoint. The tie picks up the tones in the suit and shirt, and the large paisley adds a contrast in scale.

The New Pattern Suit

In power dressing today, mini-herringbones, faint glen plaids, and window-pane patterns are barely perceptible. **STRIPES ARE ALWAYS POPULAR**, in any number of variations: from beaded to multitone track to shadows, or even broken stripes. Here, the deep navy suit has a faint herringbone pattern, accented with dual stripes. The traditional tattersall in navy and black looks elegant worn paired with the navy of the suit. The regimental stripe silk tie, with new wider spacing in the stripes, balances the look.

The Classic Evening Suit

The black suit serves as the appropriate dress for an elegant dinner—and still works fine in the office. The new models feature **WOOLS AND WORSTEDS** in chalk or variegated stripes, and the fabric has a finish that is flat as opposed to textured, with a hint of sheen. Nothing makes a suit quite so formal as a white dress shirt and solid tie. Here, a chevron pattern is worked into the shirt cotton. The (gold) silk tie has a white **PIN-DOT WEAVE**, adding to the richness of the look.



SHIRTS ETC.

Luxurious pairings and key accessories can make your old suits look and feel new again.

Does your suit collection look a bit tired these days? You could dump it in the Goodwill bin and order a whole new wardrobe. But the quickest and most cost-effective way to perk up your closet is by adding some new, yet classic, shirt-and-tie combinations.

Try a striped shirt with one of the revived collar styles—English spread, eyelet, tab, Windsor. Then jazz it up with a solid tie that picks up an accent color from the stripes. Shades of purple are popular, and they'll look great with your old gray and dark-blue suits. Other accessories can add flare to those duds. Once again, cocoa or brown suede dress shoes are stylish and should be worn with a solid or chalk-stripe navy or charcoal suit. A new watch that recalls Old World sensibilities would also be a worthy addition. We're showcasing a few models that may cost an arm and a leg. But many watchmakers offer retro styles in more popular prices, too.



▲ COLOR CLASSICS

The pure cotton dress shirt (\$265) features a banker's stripe in purple and white, with French cuffs. The regimental tie (\$125) is energized with diagonal stripes of black and purple.

Both are by Ralph Lauren Purple Label; the sterling silver cuff links (\$250) are from Oxford.

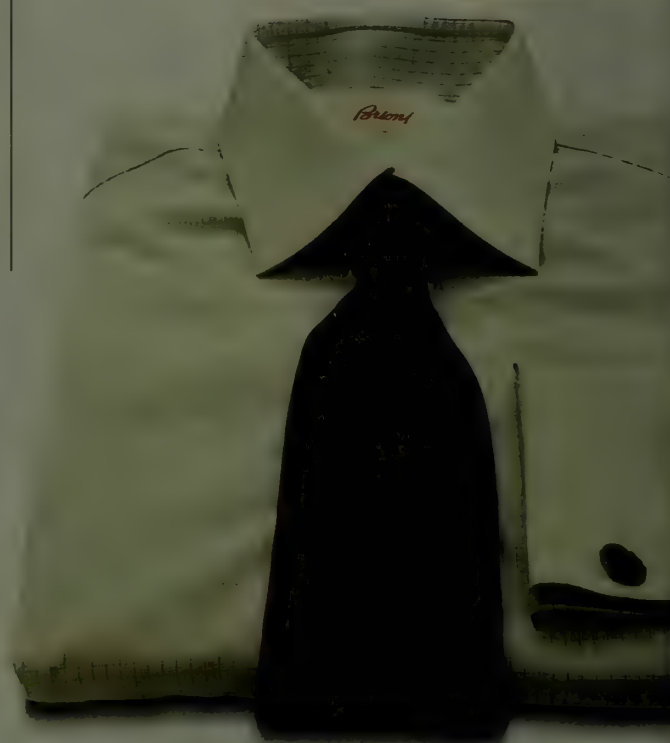
▼ SPEAK SOFTLY

A monogram is considered elegant when placed on the left of the shirt just above the waistline, where it is hidden in a suit jacket. After all, discretion is an integral part of personal style.



► GRAPHIC DETAIL

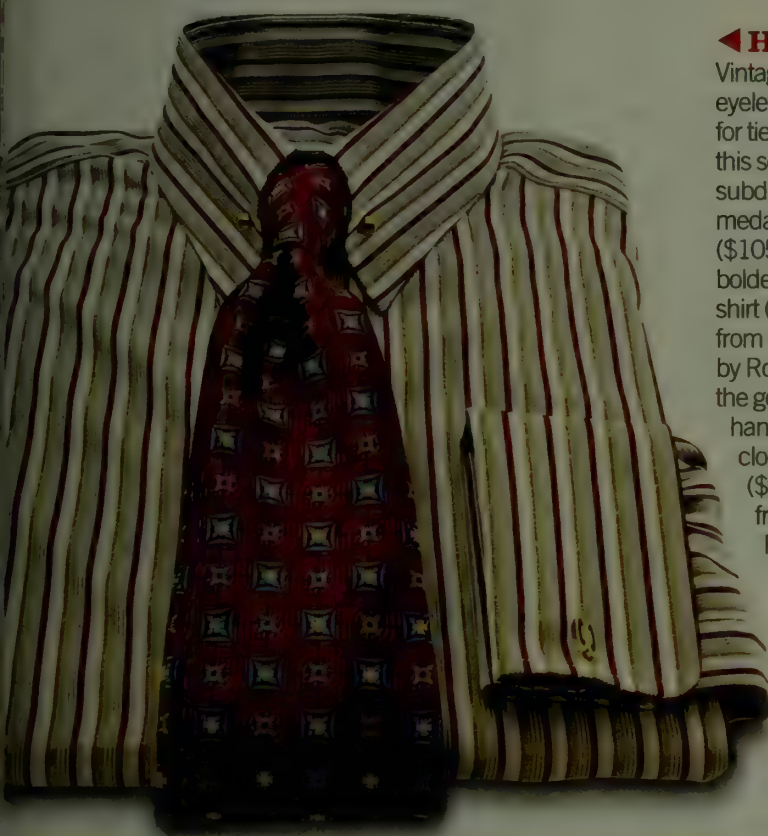
The mini-graph-check shirt (\$445) in shades of brown and blue against an ecru background is dressed up with French cuffs and rounder collar points. It's paired with a richly woven, color-blocked stripe silk tie (\$140). Both are from Brioni; the two-toned sterling silver cuff links (\$395) are from Oxford.



STAGE LOOK, MODERN MECHANICS

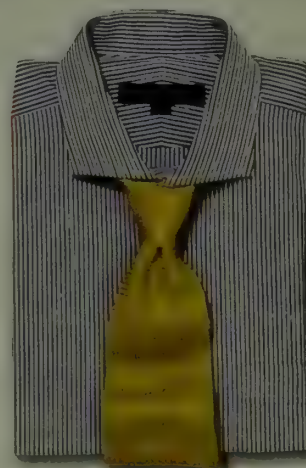
es offer as good an example as any of retrofitting today's technology into classic designs. The **CARTIER ROADSTER** (\$10,000; top) has a face shaped like the radiator grille of a sports car—even its stem echoes a radiator cap. The **BIG PILOT'S** watch (\$11,000; bottom right) is reminiscent of an early pilot's timepiece but adds a modern round face.

The **ROGER DUBUIS WINDOWS PERPETUAL CALENDAR** (\$46,900; bottom left) mixes handcraftsmanship with a modern, proprietary mechanical movement. The master watchmaker from Switzerland has made only three. Wearing one is like displaying a work of art. These watches are available at Cellini in New York, 1-800-Cellini.



◀ HOLE IN ONE

Vintage stripes and eyelet collars with holes for tie bars have appeal this season. The subdued geometric medallion silk woven tie (\$105) anchors the bolder awning-striped shirt (\$225). Both are from Best of Class by Robert Talbott; the gold and hand-enameled cloisonné cuff links (\$950) are from Estate by Robert Talbott.



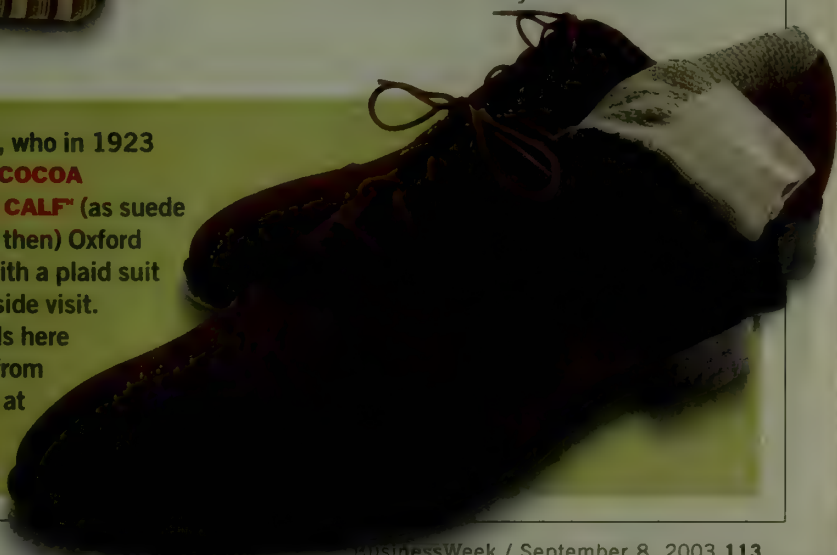
▲ TIMELESS TIP

A solid tie offers dependable style that never goes out of fashion. Today's solids are richly colored in luxuriously textured silk miniweaves. Take a shirt with multicolored track stripes and pair it with a solid tie that accentuates the bolder stripes. Shirt (\$127.50) from Hickey Freeman; tie (\$105) from Best of Class by Robert Talbott.

FRESH CHOICE FOR OUR FEET

This season's nod to the past makes brown suede **OXFORD LACE-UP SHOES** look stylish with a solid or chalk-stripe navy or charcoal suit. They are much fresher looking for daytime than the black polished calf lace-ups you might instinctively reach for. This classic was introduced by the Duke

of Windsor, who in 1923 paired his **COCOA "REVERSE CALF"** (as suede was called then) Oxford lace-ups with a plaid suit on a Stateside visit. The Oxfords here are \$338 from Peal & Co. at Brooks Brothers.



WHY A \$3,000 SUIT?

Because both Brioni and Oxxford deliver custom-tailored quality off the rack.

For decades, Oxxford Clothes of Chicago and Rome-based Brioni have set the standard in sartorial elegance available right off the rack. The cost that is hardest to budget is time, and these ready-made garments eliminate the need for the complex, often tedious fittings that a custom suit demands.

Brioni, whose customers include Britain's Prince Andrew, Donald Trump, Nelson Mandela, and Peter Jennings, has elevated fine tailoring to a modern art form by merging

Sharp Plus

The average Brioni suit is about \$3,250 and can go considerably higher depending on fabric, easily making Brioni the most expensive off-the-rack garment on either side of the Atlantic.

THE CLOTH

All the fabrics that go into Brioni clothing are exclusive. Many, such as the famous "Pope's Cloth"—used by the Vatican for its Papal robes—are so lightweight only Brioni's craftsmen are able to properly tailor them.

THE FIT

Consistent shoulder construction—soft yet structured, with each individual shoulder set in and sewn completely by hand—adds to comfort.

THE SEAMS

From the sides of the jacket to the trousers, every seam is reinforced by hand (rather than fused) with linen tape so the edges lie flat and smooth.

THE PANTS

Every trouser is half-lined to the knees with a lightweight

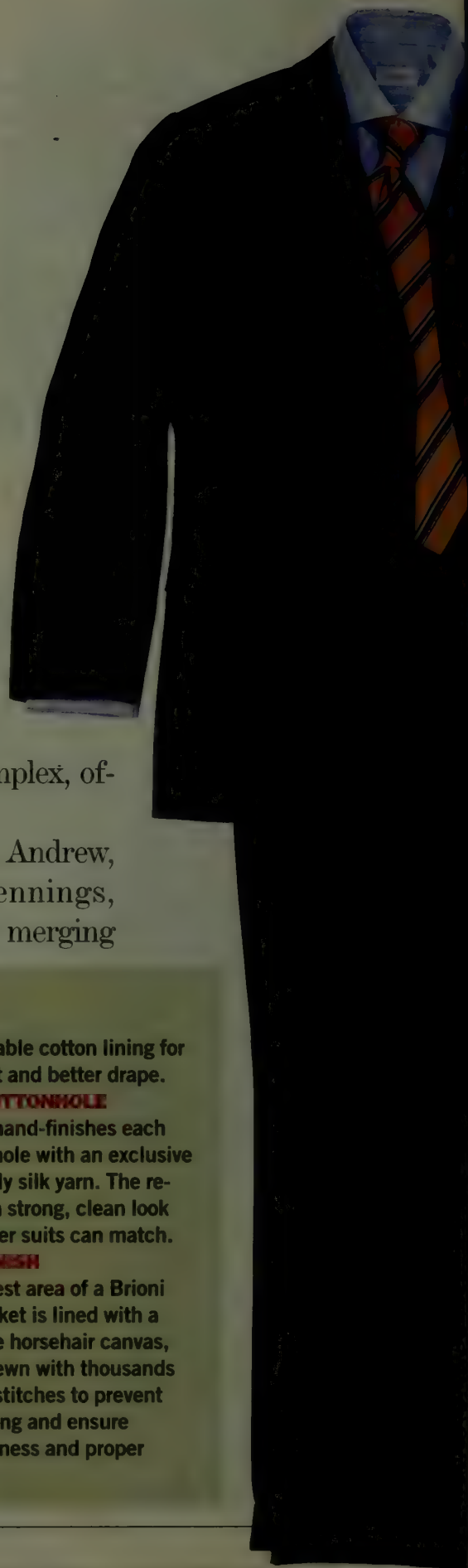
yet durable cotton lining for comfort and better drape.

THE BUTTONHOLE

Brioni hand-finishes each buttonhole with an exclusive three-ply silk yarn. The result is a strong, clean look few other suits can match.

THE FINISH

The chest area of a Brioni suit jacket is lined with a genuine horsehair canvas, hand-sewn with thousands of tiny stitches to prevent puckering and ensure smoothness and proper drape.



WHY BONE MAKES BETTER BUTTONS.

[AND OTHER SECRETS OF A CUSTOM-MADE SUIT]

What's wrong with plastic? Just about everything. They crack or break and look just like, well, plastic. What's right about bone? Everything. They have a texture and luster that compliments and enhances fine fabric. Bone buttons will last the lifetime of our suits. This passion for detail is what makes a Jiwani suit perfect for the man or woman who cares about the finer things.



Here are a few of the many Jiwani details.

- Fabric pattern matched for lapels, often overlooked but always noticed.
- A functional pen pocket.
- A useful cell phone or PDA pocket.

Jiwani has 30 years experience designing and creating custom suits. He uses only the top name fabrics such as Zegna, Versace, Holland & Sherry, Dormeuil and Toro Piana to name but a few. And in the fine tradition of a custom clothier, they will come to your office or home for a personal fitting. Just another detail that makes the difference. But perhaps the most surprising detail of a Jiwani suit is its price. The price for these guaranteed, well designed fitted suits start at \$900. Experience all these details for yourself.

CALL FOR A PRIVATE SHOWING TODAY.
(800) 14H ORS (800 824 5677)





STAR POWER

Brioni suits have a long history in Hollywood. Above, Pierce Brosnan sports Brioni as James Bond in *Tomorrow Never Dies*, and below, Clark Gable gets fitted for a Brioni in the 1950s.



technology and craftsmanship. Along with the state-of-the-art factory in Penne, Italy, Brioni has a tailoring school so masters can teach the Brioni way.

What do you get? Luxurious fabrics, including the finest super-spun wools, cashmere, and baby alpaca, are highly hand-tailored, allowing a suit to mold to the body after a few wearings. Tailoring details such as working buttonholes on the jacket cuffs, button-through

flies, even cigar pockets, are often available as an option.

The workmanship is incredibly labor-intensive. An Oxford jacket lapel has a gentle roll that comes from 1,100 hand stitches that expertly and invisibly connect the jacket fabric to its canvas facing. (The jackets are half-lined so you can look inside and count the stitches.) The Oxford waist clip settles into the tiniest of handmade buttonholes.

For what you'd spend on a suit like this, you can undoubtedly go to the finest custom tailor in your area. Then again, when you invest in these names, you're buying superb quality with a minimal investment of time. ■

SUIT LINEAGE

While the man in the gray flannel suit could sum up his work wardrobe in one cut, and one fabric, today suit manufacturers realize that dressing is also a reflection of one's multifaceted lifestyle. Now, as with cars or wine, there is a hierarchy in the fine suit lines. The same brand can take you from a casual business dinner or weekend conference to a boardroom presentation or formal dinner. With prices for entry-level suits starting under \$600, one of these respectable lines may well be within your reach.

ERMENEGILDO ZEGNA

Napoli Couture	For those who delight in extraordinary quality, the tradition and extensive workmanship of a sartorial suit. Highly hand-tailored, optional button-through fly, exclusive fabrics.	\$2,600
Sartoriale	Quintessential Italian clothing built with finesse and flair. Renowned for Super 100's specialty fabrics.	\$1,600
Z Zegna	New this season, well-priced and fashion-driven as characterized by ads featuring Oscar-winner Adrien Brody.	\$800

PAL ZILERI

Sartoriale by Pal Zileri	Dressier, formal fabrics, impeccable finishing, highly hand-tailored.	\$1,800
Pal Zileri	A modern, sexy approach to classic Italian suits.	\$1,200
Pal by Pal Zileri	Younger, more cutting-edge line.	\$800

GIORGIO ARMANI

Giorgio Armani Black Label	Old World handcraftsmanship for a sober business suit with the distinctive Armani drape. Sold exclusively in Giorgio Armani shops.	\$2,000
Giorgio Armani Collezioni	Still the most sought after label in Italian fashion, first popularized in 1980 when worn by Richard Gere in <i>American Gigolo</i> .	\$1,400
Emporio Armani	A younger collection that reflects Armani's more spirited, inventive ideas.	\$800

POLO RALPH LAUREN

Ralph Lauren Purple Label	The fitted look of Savile Row designed to Ralph's personal style.	\$2,900
Polo by Ralph Lauren	Clothing that defines English-inspired American classicism.	\$800
Chaps	The Ralph Lauren look interpreted for the younger, style-conscious man.	\$400

JOSEPH ABBOUD

Black Label	Better side-vented American clothing expertly made from select Italian fabrics.	\$800
Joseph Abboud	Distinguished by monochromatic palettes that give a modern edge to traditional American design utilizing select European fabrics. A favorite of sportscasters including Bryant Gumbel and Bob Costas.	\$600

BROOKS BROTHERS

Golden Fleece	A new line of high-end suits inspired by the Brooks Brothers archives.	\$1,000
Brooks Brothers 1818	The classic three-button, natural shoulder American suit, updated and improved.	\$700
Brooks Ease	Sold as separates, wrinkle resistant, good for travel, extremely comfortable, super 100 pure wool.	\$500

*Starting price **Average

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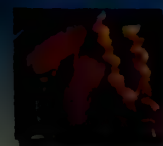
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IS A LOW-FIBER DuPONT MORE APPETIZING?

BY ROBERT BARKER rb@businessweek.com

MOST EVERYONE KNOWS DuPont for its familiar synthetics—Lyera and other fibers that have become ubiquitous in carpets and clothes. Soon, though, DuPont will be out of those lines. Its Textiles & Interiors segment brings in more revenue than any other, but DuPont disclosed in August that it hopes to sell T&I to privately-held conglomerate Koch Industries.

For DuPont, this is good news, and the reason why is no mystery. T&I has delivered far less profit than the 201-year-old giant's other businesses (table). The puzzle for investors now is whether the stock, which has climbed \$10 since March, to 45, on hopes for an economic recovery, already reflects potential for better profitability. My bet is it does. If I'm right, I'll take no glee in it. Long-term investors have already suffered plenty, with the stock topping out in 1998 above \$84. Just the same, if you take management at its word and look soberly at DuPont's remaining lines, you'll find small reason to view the stock as an odds-on market-beater.

Naturally, DuPont has its bright spots. While it's keeping mum about how much it might get for the T&I segment, I estimate it may bring \$5 billion or more. That would strengthen DuPont's already strong balance sheet and enable a larger stock buyback program. Moreover, from the company's



SCOOTING UP PROFITS

DuPont makes a key component for this scooter's fuel cells

80-some business hot products pop the time. Today, include the cr membrane it ma hydrogen fuel ce new insulating lab soft-drink conta called CoolGo, an ergy-saving org light-emitting d

(OLED) displays. One of these just rea consumers can be seen in APED, Evo Technologies' \$280 MP3 player.

Yet DuPont's future remains anchor some mature, cyclical businesses. Ev it shrinks its exposure to the textile carpet industries, DuPont's relianc sales of paints, plastic parts, and mo

autos will rise. Ditto its big position in construction m als and in the agricultural seed and chemical markets. products hold the potential for much bigger sales if bi neered foods overcome the resistance of many consu But such a great leap forward remains over the horizo

DuPont's stated goals are, in fact, notably modest: a revenue growth of 5% to 6% and earnings-per-share gr averaging 10%. It reckons that per-share profits can faster than sales through productivity gains, by s enough new products each year that average prices margins rise, and by using surplus cash to buy back sh If DuPont hits these targets, what might an investor ex say, in the next three years? DuPont pays dividen \$1.40 a year, good for a fat yield of 3.1%. A spokesw told me that despite this year's reduction in taxes on dends, no hike in DuPont's payout is likely soon. So as that three years of dividends will come to \$4.20.

Next, note that Wall Street's forecast of DuPont's earnings is \$1.80 a share. Because T&I is on track to tribute little to this year's earnings, \$1.80 a share is a sonable base for forecasts of DuPont's earnings in the fi when the segment is out of the mix. Let's just say Du piles up 10% growth in profit each year. Then by 20 would be earning \$2.40 a share. Today, DuPont trades times 2003 earnings—or 2.5 times its long-term growth. If the stock were still to command this premium multi 2006, the shares would go for \$60. With dividends works out to a total return of more than \$19 on a \$45

What's wrong with that? Nothing, but it assumes management makes good on its promises and that the keeps trading at a premium multiple. Dial back the ear multiple to a more middling 20, and the 2006 profit mak a \$48 stock and, with dividends, a three-year total retu just 16%. DuPont's good news is already in the stock.

Pieces in the DuPont Puzzle

SEGMENT	SALES	OPERATING INCOME	WHAT'S UP
Agriculture & Nutrition		\$5,022	\$648
Coatings & Color Technologies	5,265	468	Seeks growth in soy milk demand
Electronic & Communications Technologies	2,694	175	Closely tied to auto production
Performance Materials	5,103	416	Makes key component in fuel cells
Safety & Protection	3,810	536	Promising CoolGo insulating soft-drink labels
Textiles & Interiors	6,655	114	Fastest-growing, most profitable segment
			This low-margin giant is up for sale

Operating income is after tax; all figures are in millions for 12 months ended June 30, 2003

Data: Company reports, BusinessWeek

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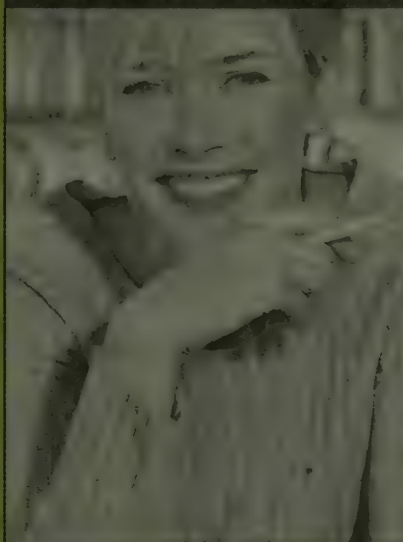
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Nextel's Next Feat?

Although Nextel Communications (NXTL) has been a live-wire act—rocketing from 6.70 a share on Sept. 3, 2002, to 17 on Aug. 27—the big U.S. wireless carrier is still the top stock to buy for some pros. “It could double in 18 to 24 months, on the rapid earnings growth we see,” says Graham of Tanaka Capital Management, which owns shares. Its Growth Fund is up 35% this year, vs. the Standard & 500-stock index’ 14% gain. (Last Nextel was featured here at 7.19.) outfit that long lived on hope, is now a play on real “quality,” says Tanaka. It trades at just consensus 2004 estimates. Nextel’s to the business trade and high-individual markets—for its Direct service that provides phone at the push of a button. Not yet ed in the price, says Tanaka, is ential of Nextel’s growing govern- business—now less than 10% of sales. That could triple in e of years, he figures, as Nextel seeks more spectrum y. Also potential winners: the family and youth markets. plus new products, such as phones with access to erry and Web data, should fuel growth, says Tanaka. added 591,000 subscribers in the second quarter, mak- ase of 12 million, up from 10.6 million in 2002. r a stock in a struggling industry, Nextel has turned in that have impressed the Street,” says Charles Hill, re- director at Thomson First Call. He notes that of 33 an- 19 have “strong buy” or “buy” ratings. Only two rate it ” Consensus earnings estimates are \$1.08 a share for h sales of \$10.2 billion, and \$1.44 for 2004 on \$11.4 billion. t Eric Weinstein of Credit Suisse First Boston sees earning \$1.19 in 2003 and \$1.66 in 2004.

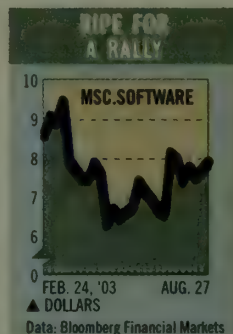


TANAKA

MSC Software: Poised to Catch the Tech Bus

Tech stocks that haven’t yet joined the rally are sparking investors’ interest. One such is Big Board-listed MSC Software (MNS), which makes software that simulates the performance of products before they are manufactured. They help producers more cost-efficient aircraft, autos, and electronics equip-

ment. In a slow economic recovery, “the game is about improving productivity,” says Joseph Battipaglia, chief investment strategist at Ryan Beck, which owns shares. MSC’s tools should meet pent-up demand for productivity enhancers. MSC, trading at 7.95 a share, is down from its high of 11 a year ago. But Battipaglia figures it’s worth at least 10, based on the turnaround in its operations and its improved balance sheet and cash flow. So far this year, he notes, cash flow has risen to 17¢ a share, up from 2¢ last year. Any lift in the economy or in tech spending will surely be a boon to MSC, he adds. Analyst Richard Davis of investment outfit Needham, who rates MSC a buy, figures it will earn 47¢ a share in 2003 and 72¢ in 2004, compared with a loss in 2002.



Breathing Easier At Lincare

Shares of Lincare Holdings (LNCR) have been on the rise, from 27 in February to 34.88 on Aug. 27—despite the Street’s skittishness about the stock. Most analysts worry that Lincare, a provider of oxygen and other respiratory-therapy services to patients at home, is subject to the vagaries of government payments. Since most Lincare patients are elderly people with chronic lung conditions, they are usually on Medicaid or Medicare. Often the government negotiates the prices it is willing to pay for such services. Yet Lincare has beat Street estimates in each of the past four quarters. To Grant Babyak, managing director at Times Square Capital Management, any dip in the stock is an opportunity to buy. Lincare has been able to withstand reimbursement rollbacks, he says, because it is one of the most efficient—if not the best—operator in the industry. Trading at 13 times his 2004 estimate of \$2.52, the stock is worth 43, or 17 times the price, says Babyak. He expects \$2.24 in 2003. Frank Connelly of Standard & Poor’s notes that Lincare’s sustainable earnings growth and low stock valuation deserve a rating of “accumulate.”



BusinessWeek online

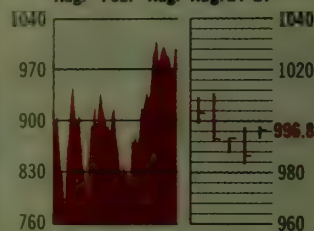
Read Gene Marcial's Inside Wall Street Online monthly column at www.businessweek.com/today.htm. And see him Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

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STOCKS

S&P 500

Aug. Feb. Aug. Aug. 21-27

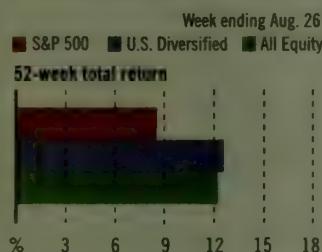
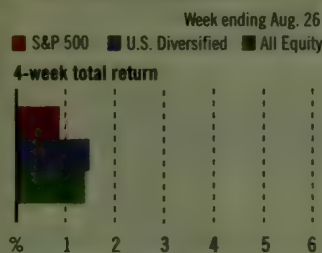


COMMENTARY

The market ended on a mixed note, with only the Nasdaq Composite Index finishing in positive turf. Semiconductor stocks propelled the tech-laden index to a 16-month high on Aug. 27, on optimism that personal computer demand is increasing. The Dow lost 0.7% and the S&P 500 fell 0.4%. Weak volume prevailed as investors wrap up summer vacations.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS



Data: Standard & Poor's

U.S. MARKETS

	AUG. 27	WEEK	YEAR TO DATE	LAST 12 MONTHS
S&P 500	996.8	-0.4	13.3	6.6
Dow Jones Industrials	9333.8	-0.7	11.9	5.8
NASDAQ Composite	1782.1	1.2	33.4	32.2
S&P MidCap 400	509.2	0.3	18.5	13.0
S&P SmallCap 600	239.8	-0.6	22.0	18.2
Wilshire 5000	9651.7	-0.2	15.7	9.5

SECTORS

	AUG. 27	WEEK	YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	570.9	-0.8	5.2	-1.8
BW Info Tech 100**	312.1	0.1	9.3	8.5
S&P/BARRA Growth	505.5	0.2	12.6	5.7
S&P/BARRA Value	487.8	-0.9	14.0	7.6
S&P Energy	197.5	0.1	7.8	1.6
S&P Financials	336.0	-2.1	13.2	5.1
S&P REIT	104.6	0.4	15.2	9.2
S&P Transportation	177.1	-1.0	4.2	-0.6
S&P Utilities	105.8	0.0	8.2	-5.5
BSTI Internet	132.2	0.7	77.0	94.7
PSE Technology	623.0	1.7	35.9	34.3

*Mar. 19, 1999=1000

**Feb. 7, 2000=1000

GLOBAL MARKETS

	AUG. 27	WEEK	YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	945.1	-3.0	1.1
London (FT-SE 100)	4206.4	-0.3	
Paris (CAC 40)	3280.0	0.0	
Frankfurt (DAX)	3483.1	-0.5	2.0
Tokyo (NIKKEI 225)	10,309.0	0.2	2.0
Hong Kong (Hang Seng)	10,678.6	1.9	1.4
Toronto (S&P/TSX Composite)	7500.6	0.1	1.1
Mexico City (IPC)	7502.1	0.6	2.2

FUNDAMENTALS

	AUG. 26	WEEK AGO
S&P 500 Dividend Yield	1.66%	1.65%
S&P 500 P/E Ratio (Trailing 12 mos.)	28.0	28.5
S&P 500 P/E Ratio (Next 12 mos.)*	17.0	17.1
First Call Earnings Revision*	-0.20%	-0.32%

TECHNICAL INDICATORS

	AUG. 26	WEEK AGO
S&P 500 200-day average	918.7	916.8
Stocks above 200-day average	70.0%	75.0%
Options: Put/call ratio	0.82	0.66
Insiders: Vickers NYSE Sell/buy ratio	4.03	3.68

BEST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Comptr. Stge. & Perphs.	19.5	202.9
Computer Stores	16.4	94.9
Health-Care Facilities	15.5	85.5
Tires & Rubber	14.6	64.9
Semiconductors	13.9	61.0

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS			
Precious Metals	8.0	Technology	35.6
Japan	6.9	Precious Metals	34.8
Pacific/Asia ex-Japan	5.3	Communications	26.5
Natural Resources	5.2	Latin America	25.3
LAGGARDS			
Health	-3.8	Japan	3.4
Europe	-0.9	Utilities	4.5
Financial	-0.7	Europe	4.6
International Hybrid	0.3	Foreign	4.7

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS			
PFds. Smicdr. Ultsr. Inv.	17.0	PFs. Intnet. Ultsr. Inv.	161.1
ING Russia A	14.7	Jacob Internet	125.4
Scudder Gld. & Pr. Mts. S	13.9	Amerindo Technology D	100.3
ProFunds Ultra Japan Inv.	12.0	RS Internet Age	86.3
LAGGARDS			
Apex Mid Cap Growth	-13.6	Frontier Equity	-71.1
Jundt Science & Tech. A	-9.0	Rydex Dynam. Vent. 100	-59.7
PFds. Wriss. Ultsr. Inv.	-7.5	PFds. UltSh. OTC Inv.	-59.6
PFs. Pharms. Ultsr. Inv.	-7.1	Potomac OTC/Short Inv.	-34.6

WORST-PERFORMING GROUPS

	LAST MONTH %
Commercial Printing	-12.2
Health-Care Distributors	-11.4
Managed Health Care	-8.6
Housewares & Specialties	-8.5
Multi-line Insurers	-7.3

INTEREST RATES

	AUG. 27	WEEK AGO
KEY RATES		
MONEY MARKET FUNDS		
	0.61%	0.63%
90-DAY TREASURY BILLS		
	0.99	0.95
2-YEAR TREASURY NOTES		
	1.97	1.80
10-YEAR TREASURY NOTES		
	4.53	4.44
30-YEAR TREASURY BONDS		
	5.31	5.29
30-YEAR FIXED MORTGAGE		
	6.45	6.37

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Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.	
10-YR. BOND	3.0
GENERAL OBLIGATIONS	
	4.11%
TAXABLE EQUIVALENT	
	5.87
INSURED REVENUE BONDS	
	4.23
TAXABLE EQUIVALENT	
	6.04

THE WEEK AHEAD

PURCHASING MANAGERS' INDEX Tuesday, Sept. 2, 10 a.m. EDT ► The Institute for Supply Management's industrial-activity index for August is forecast to have climbed to 53%, after rising to 51.8% in July. That's according to the median forecast of economists surveyed by MMS International.

CONSTRUCTION SPENDING Wednesday, Sept. 3, 10 a.m. EDT ► Building outlays in July probably grew by 0.3% for a second straight month.

BEIGE BOOK Wednesday, Sept. 3, 2 p.m. EDT ► The Federal Reserve will release

its summary of regional economic activity in preparation for its Sept. 16 policy meeting.

FACTORY INVENTORIES Thursday, Sept. 4, 10 a.m. EDT ► Manufacturing inventories are forecast to have fallen by 0.6% in July, following a 0.2% decline in June.

EMPLOYMENT Friday, Sept. 5, 8:30 a.m. EDT ► Nonfarm payrolls in August are expected to have risen by 13,000 jobs. It would be the first increase since January. Manufacturers most likely cut 30,000 jobs, after slashing 71,000 positions in July. The un-

employment rate probably rose to 6.2% from 6.2%, and the average workweek likely inched up to 33.7 hours.

The BusinessWeek production index slipped 199.1 in the week ended Aug. 16 at, up from a year ago. Before calculation of the week moving average, the index rose to

BusinessWeek online

For the BW50, more investment data, and components of the production index visit www.businessweek.com/magazine/ext

★ Positively Minnesota

re's good news on the economic horizon in the North Star state.

he global market is ferociously competitive, but Minnesota has an upbeat attitude about meeting its challenges. Confident in its ability to compete economically, the North Star has embraced "Positively Minnesota" as its theme, and has set building on its own great strengths. It's a theme, says Gov. Tim Pawlenty, that sends a message about what Minnesota offer, to businesses and people.

ositively Minnesota is the essence of what we are — a great place to live, visit and business," says the governor. "It's also a brand, a plan, and a band of public and private partners who share our vision of attracting more than our 'fair share' of business investments. It's the front page of a most compelling story about successful businesses, edge technology and innovation, and the best quality of life in America. And with help of our partners, www.PositivelyMinnesota.com will soon become the medium through which we share that story with the world."

12th largest of the 50 states, and home to slightly more than 5 million people, Minnesota has earned a stellar reputation as a place to do business. In any number of categories, the North Star state shines. Transportation connections are outstanding, energy resources are reliable and affordable, and high-speed telecommunications are state-of-the-art. The state's educational system is acknowledged to be one of the very best. Its business base includes corporate names that are among the most recognized in the world. Last year, Minnesota companies exported an estimated \$17 billion in manufactured goods, professional services and agricultural commodities to more than 185 countries. And "Medical Alley," a 350-mile corridor that extends from Rochester through the Twin Cities to northern Minnesota, encompasses more than 8,000 health-care companies.

Minnesota also provides fertile ground for scientific and technological innovation. Two world leaders in bioscientific research — the University of Minnesota and Mayo Clinic — recently forged a multi-year research partnership to position the state as a world center in biotechnology and medical genomics. It's part of a state-sponsored initiative to provide research grants and medical talent to Minnesota.

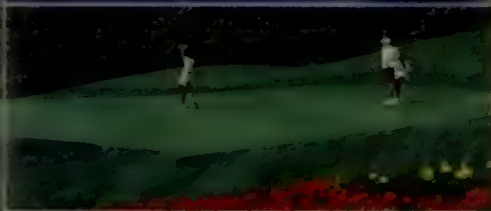
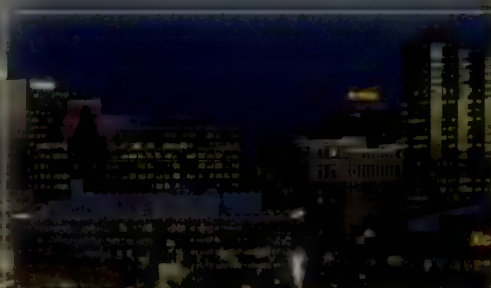
In this business-friendly environment, a vast spectrum of companies has flourished, including the state's diverse abundance of talents and resources.

Employees of ShopNBC, the nation's third-largest home shopping network, might be surprised to learn that it broadcasts live not out of Los Angeles or New York, but out of a 150,000-square-foot facility in suburban Eden Prairie, Minnesota.

ShopNBC was rebranded after NBC bought a 40 percent stake in the shopping channel in 1999,

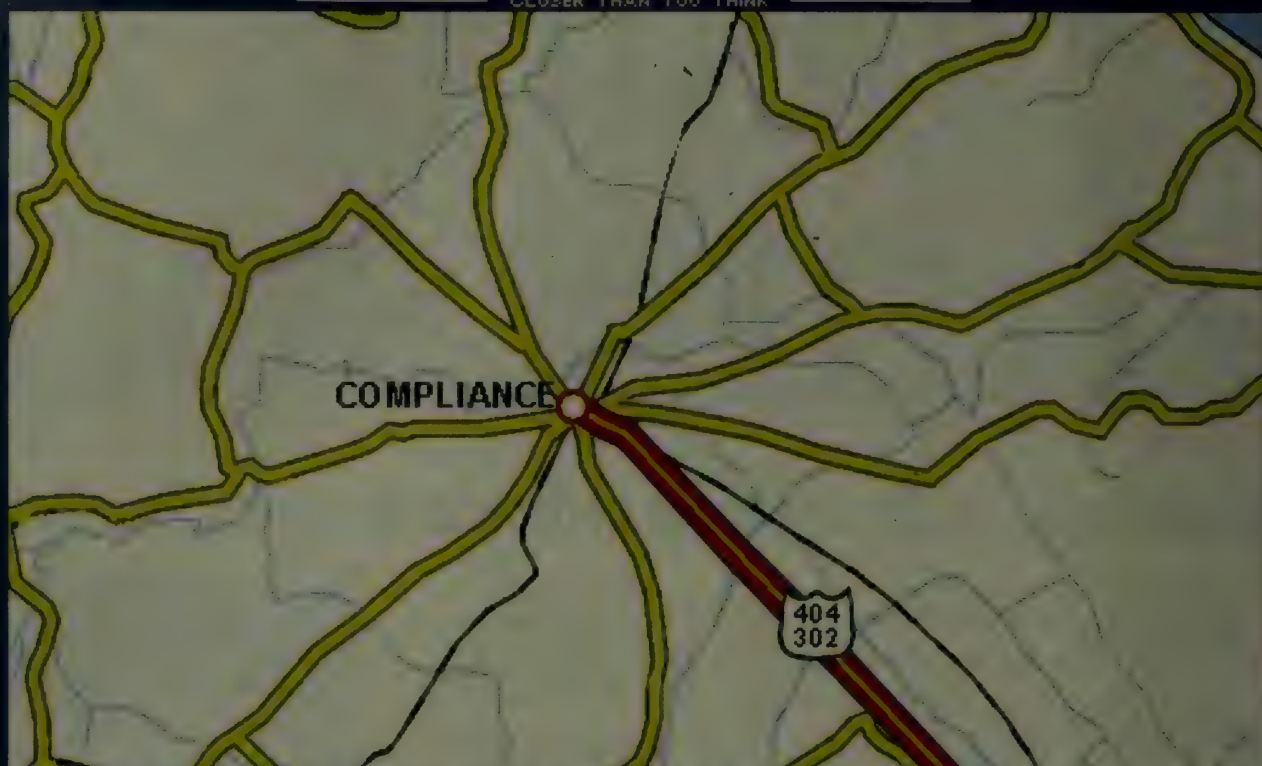


Minnesota Governor
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BC is in fact the flagship property of ValueVision Media, which operates in the converged world of television, the Internet and e-commerce. Specializing in selling high-end jewelry, consumer electronics, along with a breadth of merchandise offerings, the shopping network broadcasts to 58 million cable and satellite homes. With an average price point of \$250 and an average of \$125,000 an hour in sales, the network presents anywhere from 10 to 15 minutes of programming in 30- to 60-minute intervals.



Host Lynne Schacher at work in the ValueVision studios.

ValueVision operates in real time, with a state-of-the-art control room serving as the center of the operation. "Hour by hour and minute by minute, you know what's going on," says COO Dick Barnes, "and it's critical to running our business." ValueVision had fiscal 2002 sales of \$100 million, with almost \$100 million of revenue coming from Internet sales on ValueVision.com. This year, says Barnes, ValueVision is diversifying its products and services, and the company should have sales of between \$150 million, or about 15 percent increase over 2002.

Other enterprises also take root and flourish in Minnesota's nourishing environment. In 2001, more than 23,000 jobs were created by companies with less than 50 employees. Many began as recently as Paisley Consulting, Inc. It wasn't so long ago that Stacey Welu sat in the extra bedroom of her home struggling to write a software program that would enhance her performance as an auditor. Self-taught and motivated, Welu came up with a software program — AutoAudit — that became the foundation of a new business. By the end of 2001, she and husband Tim Welu were running Paisley Consulting, Inc., with Stacey handling the production end, and Tim in charge of sales and marketing.

"We're a computer software company specializing in business accountability software," explains Tim Welu. The corporate governance scandals of the late 1990s, he says, were a boost for business.

AutoAudit remains a flagship product of the company, which is located in Cokato, Minnesota, about an hour west of the Twin Cities. The company has also added an enterprise risk management tool called Risk Navigator as well as Focus control assurance software to support the Sarbanes-Oxley Act of 2002, which brought about sweeping accounting and corporate reforms.

What was once a mom-and-pop business now employs 75 people and has clients in more than 30 countries. Tim Welu estimates revenues should reach \$10-\$11 million this year.

Minnesota can point to successes such as Paisley Consulting to prove that it is indeed the place to be. The evidence is even more overwhelming when the state lists its top 10 reasons for doing business in Minnesota.

1. Proven Performance: Minnesota received the highest grades for economic performance, development capacity and business vitality in 2001 and 2002 from the Corporation for Enterprise Development.

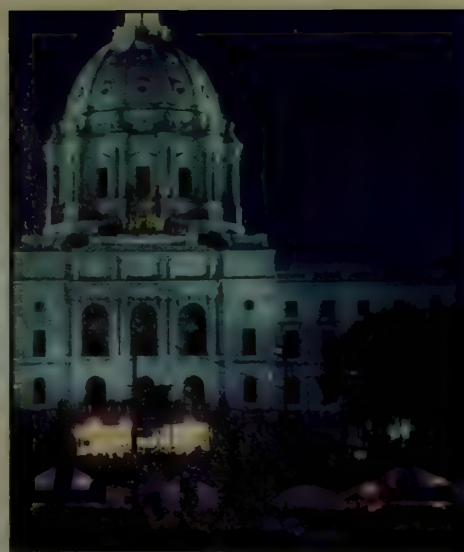
2. Business-friendly Climate: Government-imposed business costs in the state have fallen to their lowest level over the past decade. Major reforms include a 40 percent drop in workers' compensation costs, a 9 percent decline in the tax on unemployment insurance, and a 36 percent reduction in commercial property taxes.

3. World-renowned Work Ethic: Minnesota is known for its highly skilled, motivated workforce and low absenteeism. It is the nation's "hardest working" state, with the highest proportion of people in the work force.

4. Excellence in Education: The University of Minnesota ranks among the top three public research universities in the nation, and 82 of the state's public primary and secondary schools are cited for academic excellence by the U.S. Department of Education.

5. Fertile Ground for Innovation: Minnesota is one of the nation's top seven technology states, according to a 2001 report by the Massachusetts Technology Collaborative.

6. Best in the Business: Some of the world's most recognized corporations



Minnesota Office of Tourism ©

In St. Paul, Minnesota's State Capitol was designed by architect Cass Gilbert and completed in 1905. The domed structure was modeled after Saint Peter's in Rome.

make their home in Minnesota, and the state is one of only three in the country with at least six Malcolm Baldrige National Quality award winners.

7. Foundations of Commerce: The Minneapolis-St. Paul International Airport is the world's 16th busiest airport and overall customer satisfaction is tops in North America and among the top five worldwide.

8. Global Competitor: Since 1997, the state's manufactured exports have increased 12 percent to nearly \$9.5 billion in 2002.

9. A Wealth of Resources: Minnesota is richly endowed with the expertise and capital needed to support businesses at every stage. Minnesota ranked 14th in the country — tops in the Midwest — in venture capital investments in 2002, with more than \$325 million.

10. A Most Livable State: For the seventh straight year, Minnesota tops Morgan Quitno's "Most Livable State" rankings, based on indicators such as affordable housing, safe streets, a strong education system and excellent health care.

For these reasons and many more, when the question is business, the answer is positively Minnesota. ■

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Index to Companies

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Listed only in tables are not included.

ACN 105
Boors 68
da 28, 128
Beverages

Capital
ment 86
Group (AZ) 50
(ALL) 24
O) 46
Airlines
4
n Eagle
rs (AEOS) 86
r-Busch
8
e Warner
6
C) 28
Computer
40
8, 12, 96
ey 50
50

munications
America
es (BAC) 88
e (ONE) 8

Point 32
arns (BSC)

Group 52
e Hathaway
4

BA) 46
14
Brothers 112

an 68
n (CEPH) 88
CHIR) 102
(DCX) 78, 80

Cisco Systems
(CSCO) 12
Citigroup (C) 16, 42,
54, 68
Clayton Homes 44
Comcast (CMCSK)
76, 92
Compass
Bancshares (CBSS)
12
Compete 78
Computer Economics
28
Comverse Technology
(CMVT) 88
Conference Board 25
Counterpane Internet
Security 28
Covad
Communications
(COVD) 96
Crédit Lyonnais 50
Credit Suisse First
Boston (CSR) 68,
88, 90, 121
CSX (CSX) 28, 128

D
DaimlerChrysler
(DCX) 50, 80
Dana (DCN) 80
Dealogic 90
Deutsche Bank (DB)
68
DirecTV (GMH) 40, 76
DuPont (DD) 118

E
EarthLink (ELNK) 36
eBay (EBAY) 92
EchoStar
Communications
(DISH) 76
EMI 40
Enron (ENRNQ) 8, 24
Evolution
Technologies 118

F
Fairchild
Semiconductor (FCS)
46
Fannie Mae (FNM) 42

FedEx (FDX) 12, 83
Ford (F) 46, 78, 80,
110
Forrester Research
(FORR) 52, 92
Fox Entertainment
(FOX) 76
Freddie Mac (FRE) 42
Freightliner 80
F-Secure 32

G
Gap (GPS) 102
Gartner 28, 52, 92
GE Capital (GE) 16
Gemstar-TV Guide
International (GMST)
76
Genentech (DNA) 102
General Motors (GM)
28, 78, 80, 83, 88,
109
Geron (GERN) 102
Goldman Sachs (GS)
50, 90

H
Halliburton (HAL) 24,
52
HeidelbergCement 90
Heineken (HINKY) 68,
72
Honda (HMC) 80
Hyperion
Development 8

I
IBM (IBM) 24
Intel (INTC) 92, 102
Interbrew 68

J
Johnson & Johnson
(JNJ) 102
Johnson Controls
(JCN) 80

K
Kaufman Brothers 96
Koch Industries 118

L
Lazard 50
Lear (LEA) 80

Li & Fung 54
Lincare Holdings
(LNCR) 121
Lockheed Martin
(LMT) 46, 128
Long-Term Credit
Bank of Japan 16
Lowe & Partners
Worldwide 68

M
Manatt Phelps &
Phillips 40
Martha Stewart
Living Omnimedia
(MSO) 46
Mazda (F) 46
McAfee (NET) 18
McDonald's (MCD) 41
McGraw-Hill (MHP)
86
MCI 46, 96
Mellon Financial
(MEL) 16
Mercedes-Benz (DCX)
80
Merck (MRK) 12
Merrill Lynch (MER)
76, 86
Microsoft (MSFT) 18,
28, 92, 128
Mitsubishi 16, 41
Moody's Investors
Service (MCO) 90
Morningstar 86
Motorola (MOT) 52
MSC Software (MNS)
121
Multex 86

N
NASDAQ Stock
Market (NDAQ) 12
NDP Group 40
Needham 121
Netscape (AOL) 8
Network Associates
(NET) 32
New Enterprise
Associates 92
News Corp. (NWS) 76
Nextel
Communications
(NXTL) 121

Nissan (NSANY) 78,
80
O
Omnicom (OMC) 88
Orascom Group 52
Orbis Investment
Management 44
Oxford Clothes 112,
114

P
Paramount (VIA) 76
Polaroid 8
Polo Ralph Lauren
(RL) 112
Precursor Group 86,
96
Prudential Financial
(PRU) 86

R
Reuters Group
(RTRSY) 86
RHK 92
Ripplewood Holdings
16
Ritz Camera 109
Roadway (ROAD) 83
Royal Philips
Electronics (PHG) 50
Ryan Beck 121

S
SABMiller (SBMRY)
68, 72
Sanford C. Bernstein
(AC) 86
SBC
Communications
(SBC) 40, 92
Scios (SCIO) 102
Seat Pagine Gialle 90
Showtime Networks
76
Sidoti 86
Siebel Systems
(SEBL) 46
Silicon Graphics (SGI)
8
Smith Barney (C) 86
Softbank 92
Sogo 16
Soleil Securities 86

Sony (SNE) 40
Standard & Poor's
(MHP) 86, 90, 121
Starbucks (SBUX)
128
Symantec (SYMC) 18

T
Tanaka Capital
Management 121
Thomson Financial
86
Thomson First Call
86, 121
Times Square Capital
Management 121
Toyota (TM) 78, 80
TruSecure 28, 32
Turkcell 52
Tyco International
(TYC) 88

U
UBS Securities (UBS)
78
Unilever 68
United Parcel Service
(UPS) 12, 83
Universal (V) 40
UTStarcom (UTSI) 88

V
Value Line 86
Venture One 92
Verizon
Communications
(VZ) 28, 40, 92
Vivendi Universal (V)
76, 90
Volkswagen 50

W
Walt Disney (DIS) 76
Warner Music (AOL)
40
WebMD (HLTH) 8
Wells Fargo (WFC) 42
Wit Capital 86

Y
Yellow (YELL) 83
Z
Zagil Wireless 52
Zone Labs 18

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VIRUSES AND SPAM: TIME TO FIGHT BACK

The information economy has lost its innocence. The twin scourges of software viruses and e-mail spam are merging into a single epidemic that is overwhelming the nation's communication and information systems. The blinding speed with which SoBig and Blaster disrupted corporate networks and personal computers threatens the productivity gains made possible by the Information Age. So far, it appears that the disruptions are the work of malicious and misguided hackers. But it's only a matter of time before national security is threatened by hacker mayhem. Washington, Corporate America, Microsoft Corp., and millions of PC users must join in a serious effort to safeguard the Internet and keep the flow of information open. Nothing less than America's prosperity and safety are at stake (page 28).

Viruses are far more than just a nuisance. Anyone working in an office knows that e-mail and computer systems are slowing down as corporations do battle with viruses. Firewalls and spam blockers are also preventing e-mails from getting through and stopping people from gaining access to many Internet sites. Communications are being disrupted and information flows are being curbed. This could have a very serious economic impact if it continues. An increasing number of companies have had their operations grind to a halt. CSX, Lockheed Martin, the U.S. Postal Service, Starbucks, and Air Canada are but a few of the companies that have been hit hard. Consumers buying new PCs are suffering as well. Many have found their laptops infected and unusable within minutes of turning them on. Trying to fix them by downloading software patches often proves to be a nightmare.

At the moment, the virus hunters are losing the fight against the virus writers. It can only get worse. SoBig is one of a new species of spam virus, born of the interbreeding between software viruses and spam. It distributed itself so widely, so fast, that virus hunters couldn't catch up to it. In fact, the proliferation of viruses and the onslaught of spam have left companies and consumers staggering.

What to do? Battling spam may be the easy part. The Federal Trade Commission should create a consumer opt-out

site for spam, just as it did with telemarketing. Telemarketers are lobbying against such a move in Congress, but overall public interest should prevail. E-mail was the app of the Internet revolution, and now people dread opening theirs each morning. Washington needs to replicate popular donotcall.gov registry with a donotspam.gov that allows consumers to receive e-mail only from choicetailers and marketers.

Fighting viruses will be much harder. The Information Age was born of a culture that celebrated openness and speed. This was especially true of the software industry where getting new products out fast and fixing bugs was the norm. This culture now has to change. Security and reliability are as important as novelty features and Microsoft in particular, as the private owner of a de facto public utility, Windows OS, has to shift its priorities. Shipping new programs that have security loopholes and then patching later to fix them is no longer acceptable. Software has to be designed from the very beginning to be as secure and loophole-free as possible. Microsoft acknowledges its responsibility and is already taking major steps to make its products more trustworthy and secure. It is notifying consumers to download patches when they are made available. Yet the very success of SoBig and Blaster shows Microsoft has a way to go.

In the end, it may well be that a high-tech monoculture based on centralized and standardized systems is making the information economy too vulnerable. Mistakes and, at chief, not to mention terrorism, may be inevitable in the 21st century. But now one failure of the electricity grid in a town in Ohio puts 50 million people in the dark. One virus that infects one basic software program shuts down corporate networks and millions of computers around the world. In the long term, reliability and security may require greater diversity in software, not less. We underestimate the threat they pose to prosperity at our peril. They have evolved into economic terrorists of the Information Age and should be treated accordingly.

DID DICK GRASSO EARN HIS BIG PAYDAY?

It may very well be that New York Stock Exchange Chairman Richard A. Grasso has earned every penny of the \$140 million he is cashing out from his retirement and savings vested during his 36 years there. After all, the NYSE has done quite well, especially during the years of his direct leadership, adding dozens of new company listings (42 NASDAQ companies defected to the NYSE in 2002 alone). But we can't be entirely sure, because the NYSE's boards of directors that gave Grasso this large sum over the years have been composed largely of the very people in the securities industry he

has been in charge of monitoring and, in effect, regulating.

We would also feel more comfortable with Grasso's compensation if he had much earlier put the NYSE in the forefront of fighting the key battles for corporate reform, against conflicts of interest, and in favor of protecting individual investors from perfidious analysts. Instead, these problems festered during his tenure and ultimately led to a loss of confidence in Wall Street and Corporate America. Grasso has just signed another two-year contract to be chairman and now has an opportunity to improve on that legacy.

September 15



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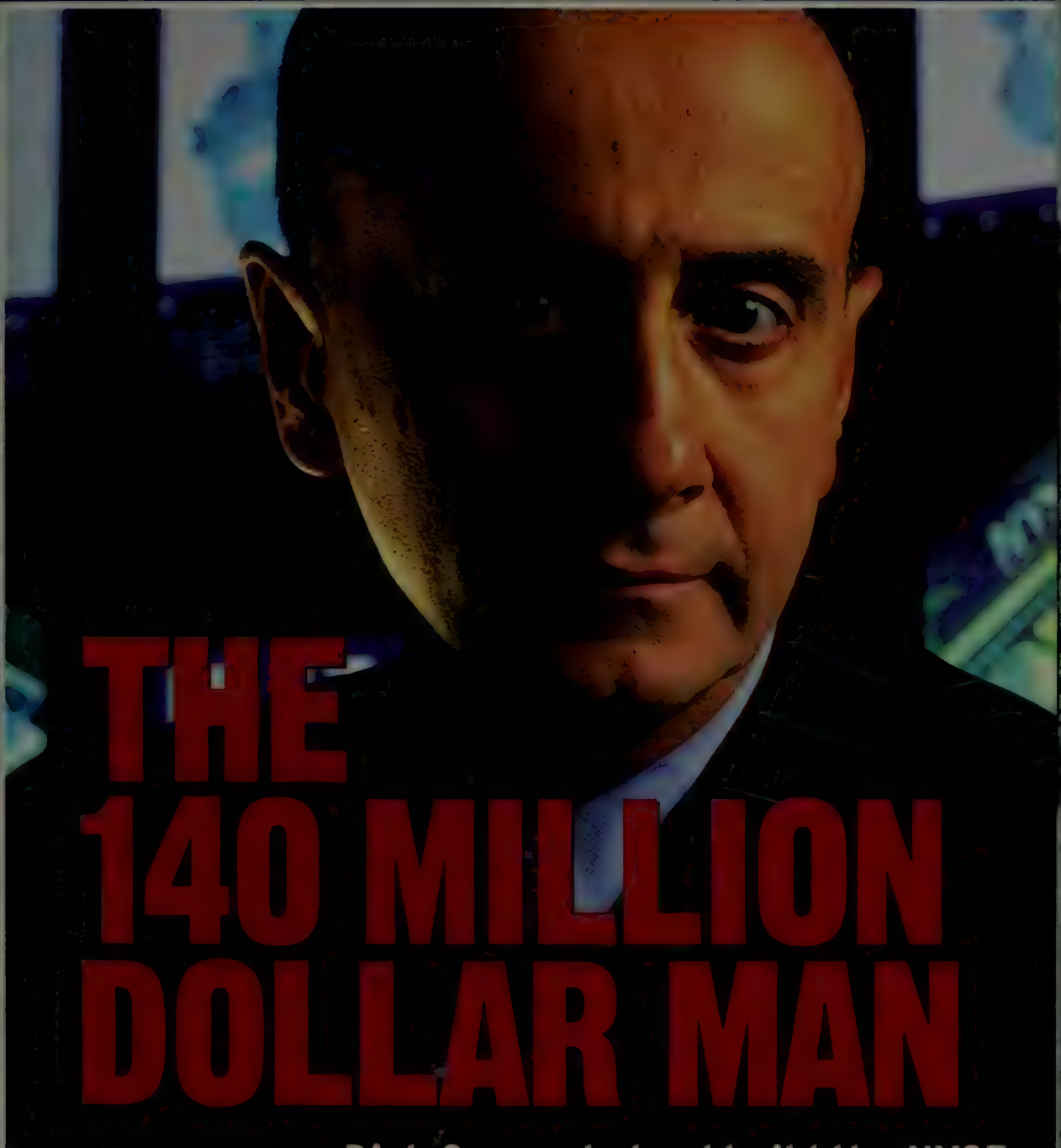
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THE 140 MILLION DOLLAR MAN

Dick Grasso helped build the NYSE into the world's premier financial market. His excessive pay reflects just how he runs the place.

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PAGE 84



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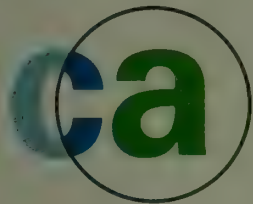
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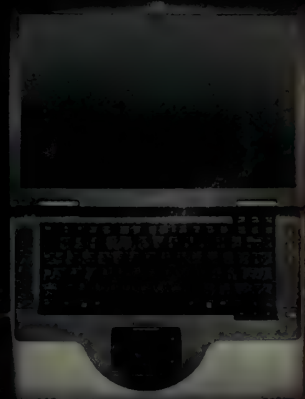
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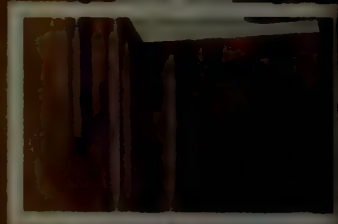
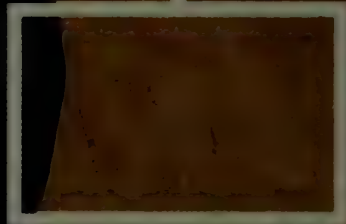
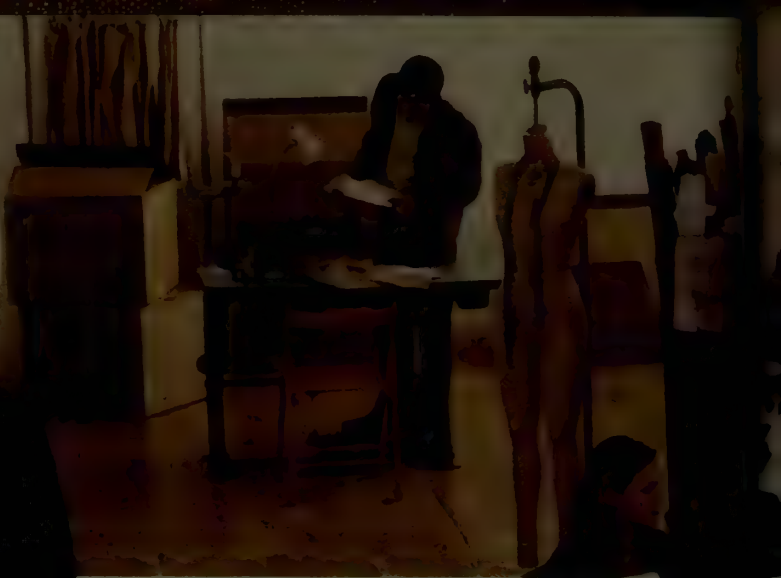
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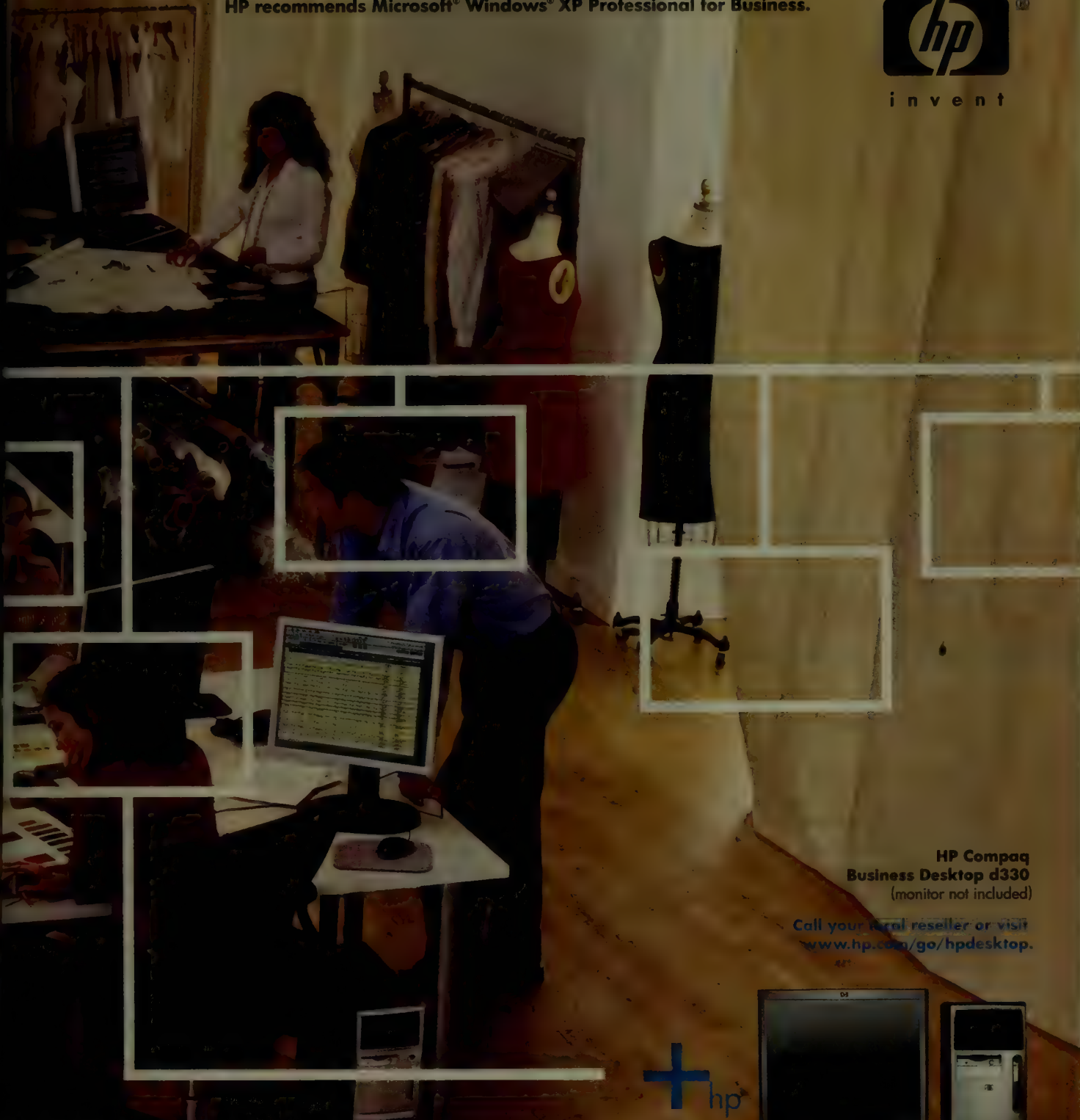
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COVER STORY

\$140 MILLION MAN

Dick Grasso's
outsize paycheck
at the NYSE is best
explained by his
street-smart skills
at dealing with
traders and his
board page 84



BusinessWeek

SEPTEMBER 15, 2003

Cover Story

84 THE \$140 MILLION MAN

Chairman Dick Grasso is the heart and soul of the New York Stock Exchange—and thanks to his extraordinary record there, the best-known and best-paid stock market exec in the world. But to Grasso's detractors, what matters most is not financial performance but his moral leadership—and there, they say, the chairman is sorely wanting. An inside look at how he runs the NYSE

News: Analysis & Commentary

32 A SURPRISE PRODUCTIVITY SURGE

The big news: Tech-driven productivity is powering profits, stock prices—and, at long last, corporate spending

34 COMMENTARY: JOBS

Losses in the factory sector have become a big political headache for President Bush

36 IS THE TECH DROUGHT OVER?

Corporate outlays on information technology are at their strongest since early 2000

38 COMMENTARY: THE FED

The price of lost credibility: Can Greenspan get across his vision of monetary policy?

40 SPITZER VS. THE FUNDS

Once again, the New York attorney general has beaten the SEC to the punch

42 ANGLING FOR THE BIG FISH

Federal prosecutors are closing in—albeit slowly—on CEO wrongdoers

44 COMMENTARY: GE

A Vivendi deal would beef up NBC profits and content, making it much more than a broadcast network

46 NEXT UP: ROLLING FREAKOUTS?

California's bill for universal health care could whomp small business—and change the national debate

48 DIVIDENDS AREN'T DAZZLING

Tax cut or no, investors are still chasing growth stocks

50 IN BUSINESS THIS WEEK

International Business

54 INSURANCE: AIG

The insurer aims to strengthen its already formidable presence in China and Japan

55 COMMENTARY: NORTH KOREA

North and South are too far apart for Washington's comfort, but Americanism is on the rise

56 CHINA: SPORTS MARKETING

Foreign companies have seen sponsorship deals fizzle out for a new game plan

59 INTERNATIONAL OUTLOOK

Libya: America's dilemma lifting sanctions

Economic Analysis

28 ECONOMIC VIEWPOINT

Becker: How out-of-control damages harm the economy

29 BUSINESS OUTLOOK

U.S.: The economy is finally on all cylinders
Southeast Asia: A big turn

Government

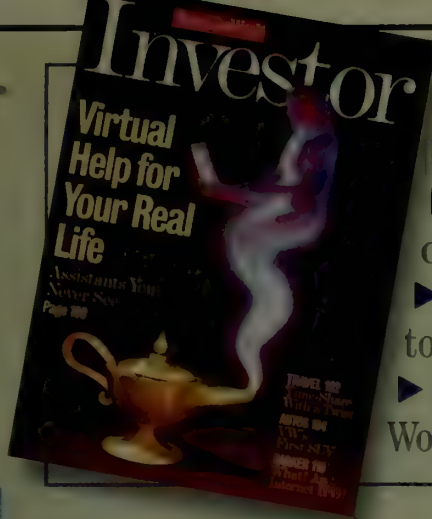
52 WASHINGTON OUTLOOK

Medicare reform: No miracle for the GOP

62 SIDESTEPPING McCAIN-FELDER

A coalition of liberal groups is raking in money—and becoming an adjunct of the Democratic

WEB CLUBS
With darknets, online
have a way to their privacy
space page 80



- Office help from afar page 100
- Luxury vacation clubs page 102
- Volkswagen's tough Touareg page 104
- RedEnvelope: Worth a peek? page 110



PRODUCTIVITY
Its growth surge is a happy surprise page 32



CRUSADER
Spitzer takes on his latest quarry:
Mutual funds page 40



AIRBORNE
Leonard's AirTran homes in on Delta page 98



NEW MILITARY-INDUSTRIAL COMPLEX
Private contractor Brown & Root is doing more of the Pentagon's grunt work page 68

Workplace

DR'S GANG OF FIVE
Leaders are discussing joining
to increase their rolls—away
the AFL-CIO

Report

SOURCING WAR
Iraq, civilian contractors are
ruling as much as 30% of
potential military support services.
KBR unit of Halliburton—Dick
 Cheney's old company—has become
 indispensable to the U.S. effort.
 Unlike soldiers, KBR employees
 say no at any time—and they
 , causing soldiers to go without
 food, showers, and toilets for
 hrs. Are U.S. troops being
 sed to catastrophic risk?

Information Technology

OSTROM: TECHNOLOGY & YOU
Products that control kids' electronic
activities can take different tacks
UNDERGROUND INTERNET
Members-only "darknets" are
ing up to protect file sharing
prying eyes

People

93 CATCH HIM IF YOU CAN
AirTran CEO Joe Leonard has got
costs so low he's outflying Delta
and the other biggies

BusinessWeek Investor

- 99 DIVIDENDS**
Yoga for highfliers; insurance for
your college-bound kids; handy
hanger; IPOs come back
- 100 NEED A VIRTUAL ASSISTANT?**
More business owners are hiring
VAs for tasks from bookkeeping to
buying gifts for Mom
- 102 LUXURY WITHOUT STRINGS**
Vacation clubs can provide you
with plush properties, flexibility,
and concierge-like services
- 103 TIME-SHARE YACHTING**
If you can't afford to buy one, get a
piece of one instead
- 104 ONE TOUGH SUV**
VW's Touareg blends luxury and
off-road muscle

104 HOT CARS: PARTS CROOKS LOVE

Most in demand by thieves are
blue-white headlights, replacement
air bags, and "spinner" hubcaps

106 INVESTING WITHOUT BLINDERS

Robert Arnott's Pimco All Asset
Fund looks beyond stocks and
bonds to emerging-markets debt,
commodities, and TIPS

108 Q&A: G. KENNETH HEEBNER

Why the manager of the hot CGM
Realty Fund doesn't fear higher
mortgage rates

110 THE BARKER PORTFOLIO

Looking inside the initial public
offering of online gift retailer
RedEnvelope

112 MARCIAL: INSIDE WALL STREET

Features

- 12 UP FRONT**
- 18 READERS REPORT**
- 20 CORRECTIONS & CLARIFICATIONS**
- 22 BOOKS**
Warren and Tyagi: *The Two-Income
Trap: Why Middle-Class Mothers &
Fathers Are Going Broke*
- 114 FIGURES OF THE WEEK**
- 118 INDEX TO COMPANIES**
- 120 EDITORIALS**

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Rich Steinberg of The Reserve Large-Cap Growth fund tells investors to ignore the "minutiae" that move the market



■ MORE MOMENTUM:

The economy needed a return of capital spending—and it's here, says BW's Jim Cooper



TOOLS

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Off and Running

With the Presidential primary season heating up, what was supposed to be an easy victory for the incumbent now looks like a race. Here are four key factors that will determine Bush's re-election chances



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Street Wise: While companies aren't hiring yet, they are handing out raises and promotions to employees they want to keep

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Up Front

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IN YOUR BACKYARD?

ity based in Richmond, Va., will most likely be first, with a filing planned for this month. Later this fall, Entergy is expected to request a permit for a new reactor at its Grand Gulf Nuclear Station in Port Gibson, Miss. Also expected this fall is a filing from AmerGen Energy, an Exelon unit that wants to expand its Clinton Power Station in Clinton, Ill.

All this activity will do little to ease concerns about future outages, however. The companies face a year-and-a-half wait for approval. A new reactor would take six to seven years to construct and cost about \$6.5 billion, figures Dominion CEO Thomas Capps.

Asking for a permit now could shave years off that timetable, although Dominion doesn't have immediate plans to build. "We're keeping our options open," Capps says. It's still a long way to new nukes. *Christopher Palmeri*

BLACKOUT 2003

NO NUKES? ON SECOND THOUGHT...

WITH THE GREAT BLACKOUT of 2003 still fresh in everyone's mind, three energy companies are planning to ask the Nuclear Regulatory Commission for permission to build new reactors. If issued, the permits would be the first ones to be granted since the early 1970s.

Dominion Resources, a util-

THE LIST THE PRICE OF SAFETY

How efficient are safety regulations? To decide, economists estimate how many lives a regulation saves, then compare that with the cost of implementing the rule. By this measure, the labeling of trans-fat content in foods is a clear winner.



REGULATION REQUIRES	COST TO SAVE ONE LIFE
LABELS SHOWING THE TRANS-FAT CONTENT OF FOODS	\$3,000
INSULATION FOR AIRPLANE CABINS TO PROTECT AGAINST FIRE	\$300,000
STATE SEAT BELT LAWS AS CONDITION FOR FEDERAL AID	\$500,000
STRONGER AUTOMOBILE SIDE DOORS	\$1.1 Million
FLAME-RETARDANT CHILDREN'S SLEEPWEAR	\$2.2 Million
REDUCTION OF FACTORY WORKERS' ASBESTOS EXPOSURE	\$5.5 Million

Data: John F. Morrall III, for the AEI-Brookings Joint Center for Regulatory Studies

TALK SHOW "The mutual fund industry operates on a double standard. Certain companies and individuals have been given the opportunity to manipulate the system."

—New York Attorney General Eliot Spitzer, announcing a settlement with a hedge fund that he accused of making illegal trades with several mutual fund companies (page 40)



FUDZY MATH

VOODOO ECONOMICS, CALIFORNIA-STYLE

WHY SHOULD CALIFORNIA FANTASIES be restricted to screenwriters? The economic plans proposed by candidates in the state's recall election outdo even Hollywood.

Lieutenant Governor Cruz Bustamante wants to hike income taxes on the wealthy and businesses, along with cigarette taxes. But he also proposes \$2 billion in tax cuts that he can't identify. Or consider Peter Ueberroth's proposal to raise \$6 billion through a one-time tax amnesty. Problem is, it would raise just \$11.5 mil-

lion, says Jean Ross, a director at the nonpartisan California Budget Project. As for Schwarzenegger's plan to hire auditors to find ways to waste, Ross says there's much fat left after slashing \$38 billion deficit.

Truth is, California has much wiggle room for close next year's \$8 billion deficit. About 75% of the budget is locked in place by ballot initiatives and constitutional requirements. That makes it nearly impossible for Ueberroth to cut \$2 billion by slashing spending 5% from the board.

The gubernatorial races would also cut \$4 billion in automobile fee hikes, but it's not clear how they would make up the gap. "The public needs to care about figures," says Schwarzenegger. "What people want to hear is if you're willing to make changes tough enough to go in and provide leadership." *Ronald*

AFTER 9/11

A FACE-LIFT FOR PASSPORTS

THE STATE DEPT. IS ASKING high-tech companies to help make American passports smarter by adding a chip that will store biometric data, most likely facial measurements. IBM and Infineon Technologies, Europe's No. 2 chipmaker, confirmed that they have responded to the request. State Dept. officials declined to identify other bidders.

There are 51 million U.S. passports in circulation, and 7 million are issued annually. At a recent tech conference, the deputy assistant secretary of state for passport services, Frank Moss, said the technology will cost

the government an estimated \$100 million a year.

The State Dept. has a deadline. By September 2004, all new U.S. passports must have a biochip. The change is called by a 2002 anti-terrorism law that also requires entry to use this technology.



SCAN: Smarter ID

How will it work? The data will be stored on the chip, which will store the unique facial measurements, such as the distance between their eyes. That info can be checked at a central database or a local scanner at the airport. "We could do away with the passport entirely," says Charles P. Ueberroth, head of security research at IBM. The chips will also be used for passports and visas to prevent counterfeit. *Paul Magn*

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Up Front



DEFENDANT
RENNERT

FAT-CAT FOLLIES

THE HOLE GETS EVEN DEEPER

MORE TROUBLES FOR TARNISHED Rust Belt baron Ira Rennert: A court-appointed trustee has asked the bankruptcy court to liquidate two of Rennert's companies. And if the trustee wins a little-noticed lawsuit, Rennert's companies may have to pay \$100 million in claims.

On Aug. 28, the trustee of Renco Metals Inc. and Magnesium Corp. told the court that the debtors were broke and unlikely to emerge from

bankruptcy. A suit filed by the trustee a month earlier alleged that the two were unable to pay their debt, because much of the \$150 million from junk bonds was used to pay dividends to Rennert's holding company, Renco Group. Both companies filed for bankruptcy in 2001. A Renco spokesman calls the charges "categorically false."

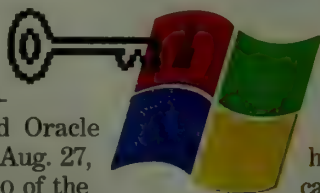
The suit is one of the first to name Rennert's associates. It alleges that accountant KPMG, banker Donaldson, Lufkin & Jenrette (now Credit Suisse First Boston), and law firm Cadwalader, Wickersham & Taft helped provide "false and misleading information." KPMG says the claims are without merit. CSFB declined to comment. And no one at Cadwalader was available for comment.

Rennert can't be too worried. He recently rejected a \$750 million offer for Humvee maker AM General from Cypress Group. Renco says it's considering all options. *Emily Thornton*

VIRUS ALERT

MICROSOFT'S SOFT UNDERBELLY

MICROSOFT'S RIVALS KNOW AN opportunity when they spot it. When a spate of computer viruses attacked Microsoft programs this summer, a trade group representing AOL Time Warner, Sun Microsystems, and Oracle pounced. On Aug. 27, Ed Black, CEO of the Computer & Communications Industry Assn., fired off a letter to Homeland Security Secretary Tom Ridge urging him to dump Microsoft. While conceding that the virus creator bears most of the blame, the letter also says: "Microsoft is also largely responsible for



continuing to create software riddled with obvious and easily exploited vulnerabilities."

A month earlier, Homeland Security had agreed to buy \$90 million worth of Microsoft programs over five years. Black says the agency defending the nation ought to set an example. The agency says it has no plans to ditch the programs. Microsoft declined to comment.

But people in glass houses ought to be careful where they fling their Windows CDs. Since January, the Energy Dept., which tracks viruses, reported seven high-risk vulnerabilities with Microsoft's software. But Sun, with two high-risk vulnerabilities, isn't blemish-free. When it comes to viruses, no software is immune. *Jay Greene*

DRAWN & QUARTERED



THE FINE PRINT

MUTUAL-FUND ADS: READER BEWARE

OH, HOW MUTUAL FUNDS MISS those bubble years. With the market's recent pop, some funds are running a type of ad popular in the boom. Trumpeting performance, they omit other info to help investors pick funds.

Take a recent Smith Barney newspaper ad. It highlights the Capital & Income Fund's 15.3% five-month return, then later shows the -9.8% one-year return and 7.8% 10-year return. A Fidelity Leveraged Company Stock Fund ad promotes a 45% five-month return, and it later shows a 4.6% one-year return and

2.9% for the life of the f

The ads are disturbing, says Morningstar analyst Gregg Wolpert, because they don't help investors understand risks. They may set unrealistic expectations. A spokesman at Fidelity says its ad gives "a good picture of the fund's performance." Smith Barney spokes



says complete performance data is useful, "especially when combined with the guidance of the financial professionals who offer our funds."

The ads contrast with a recent Long-Term Funds letter to shareholders: "Returns of this magnitude are not normal.... We caution you not to increase expectations based on these numbers." Score one for talk. *Kimberly W.*

THE BIG PICTURE

VA-VA-VA-VROOM

Ford is again teaming with racing giant Carroll Shelby to make a specialty car, for sale in about three years. Here's how much more likely shoppers said they would be to buy a car endorsed by:

PAMELA ANDERSON	25%
CARROLL SHELBY	25%
DALE EARNHARDT JR.	15%
EE IACocca	4%
JOHN DELOREAN	-12%

*CAR BUYERS SAID THEY WOULD BE 12% LESS LIKELY TO BUY A CAR WITH DELOREAN'S NAME

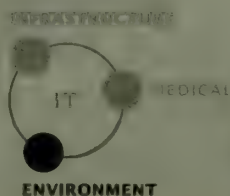
Data: CNW Marketing Research



Polls, surveys, and other items for consideration in this section should be sent to upfront@businessweek.com

TECHNOLOGY IN ACTION

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WHERE TECHNOLOGY IS HEADING

Our summer double issue, "The future of technology" (Cover Story, Aug. 18-25), prompted praise, criticism—and some new ideas.

TECH IS STILL KING

The double issue is a good example of why I have enjoyed reading *BusinessWeek* for more than 20 years. Today, our view of technology is probably as biased as it was back at the end of the Internet bubble, but in the opposite sense—too negative. For companies doing business in a highly competitive environment, there is no option but to use the best tools that are available. There will be more and more pressure to apply technology. Companies that delay investment decisions too long will run into trouble.

Information-technology innovation will continue to drive the world economy. Wi-Fi and 3G-enabled tablet PCs or notebooks create huge short-term opportunities in the field of enterprise software for mid-size companies and mobile offices. In both fields, Microsoft Corp. is going to play a leading role.

Bernd Huber
Compus Computer
Munich

WHAT NEXT BIG THING?

In "Andy Grove: 'We can't even glimpse the potential,'" Grove says: "There are huge, huge things going on, and we are too myopic to notice." This invites the obvious follow-up: "Well,

where are these great things?" I'm wondering if he really knows.

Overall, the sense I'm getting is we're in for the same old stuff.

Mark Wilk
Gainesville

GLUTTONS FOR POWER

All the tech you covered will count naught unless immediate attention is given to electrical generation and conservation, because solid-state technologies are all power gluttons.

Mony Mo
Spokane, W

FOLLOWING SOFTWARE'S LEAD

"Nick Carr: The tech advantage is overrated" is correct. Currently, Corporate America buys its software and follows the vendor's instructions to "change" its business to match the software works." In doing so, it has lost its individual competitive advantage. By contrast, American Airlines Inc. took its accumulated knowledge (the advantage) and the Saber system around it. Too many U.S. execs are letting software vendors tell them how to run their businesses.

Dennis McCa
Los Gatos,

NO MONEY FOR RISK-TAKING

In "Something ventured, something gained," Michael J. Mandel's optimistic heartening, but the problem is not



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Readers Report

CORRECTIONS & CLARIFICATIONS

In "The peacock is spreading its wings" (News: Analysis & Commentary, Sept. 1), NBC's projected 2003 operating earnings are incorrect. The figure is \$1.9 billion, an 18.7% increase over 2002. The projections cited in the story were for NBC's network alone and did not include operating profits for NBC's TV stations, cable channels, and other properties.

there isn't capital; it's that there's no risk capital. Ever wonder why venture capitalists have \$70 billion in uncommitted funds in their hands? They'll gladly drop \$5 million to \$10 million into a starving growth company with positive cash flow because those revenues will prop up the venture fund's returns. But who's willing to risk \$250,000 to \$2 million in seed capital?

Kirk Knight
Alameda, Calif.

CORE MEMORY: A CORRECTION

In "The Old Valley is history," Larry Ellison says the recent tech-industry consolidation is a boon for large, well-established companies and means the end for many small companies. He argues that innovation will increase as a result, because most innovation is being driven by large companies. He uses IBM as an example of a company that invented the "disk drive, core memory, and fractal geometry, for God's sakes."

Although IBM has invented many things in its long history, core memory's invention is generally ascribed to An Wang at the Harvard Computing Laboratory and Jay W. Forrester, head of Massachusetts Institute of Technology's Project Whirlwind. When IBM developed the first commercial computer in 1955, it stood on the breakthroughs of many talented individuals not working for large companies.

Troy Cullen
Pittsburgh

IBM'S LOST OPPORTUNITY

"The quest for the next big thing" mentioned Xerox PARC's reputation for failing to capitalize on Next Big Things. What about IBM and Deep Blue?

To write a program that would enable Deep Blue to defeat Garry Kasparov, IBM would have had to develop software that would leave hardware able to work directly with objects after the fashion of human checkout clerks—a de-

velopment that would be worth untold billions of dollars to its owners. IBM ignored this and shipped Deep Blue off to obscure number-crunching duties, missing what would have been one of the greatest software triumphs of all time.

Thomas Wulff
Stoughton, Mass.

IF YOU'RE GOING TO SEND JOBS AWAY...

"Outsourcing jobs: Is it bad?" (News: Analysis & Commentary, Aug. 18-25) is timely and provocative. I am not persuaded, however, that the so-called "better" jobs that replace those lost are seen that way by those who did the losing but don't qualify for the new jobs.

Moreover, the share of degree holders is not the panacea Michael J. Mandel seems to think. If 100% of Liechtenstein's 33,000 citizens had degrees in European history, they would be no threat to China, where just 10% of its population holds engineering degrees.

Dennis Rocheleau
Fairfield, Conn.

As an American MBA and consumer, I want U.S. businesses to play fair. If jobs are outsourced to another nation without restriction, I want the opportunity to purchase the products now manufactured more cheaply in other nations, also without restriction. Tariffs were created to protect U.S. business and jobs. If the jobs are no longer in America, the tariffs should be eliminated.

A global economy should mean a global economy, period.

Rhoda Blecker
Reseda, Calif.

ANOTHER LOOK AT WORK VISAS

"Too many visas for techies" (News: Analysis & Commentary, Aug. 18-25) portrays the H1B and L1 visas as reserved for technology workers. They are not. Many of my clients are hiring nurses and doctors using H1Bs. By the end of this decade, the shortage of nurses in this country will be in the hundreds of thousands, while the Health Policy Institute estimates that in the next two decades, we'll have 150,000 too few doctors. When the H1B quota is cut, the American public will be hurt.

As for L1s, they are heavily used by senior executives and managers coming to the U.S. to oversee the operations of multinational companies investing in this country. Sooner or later, American companies trying to develop overseas mar-

kets are going to face similar obstacles imposed as a form of retaliation against protectionist U.S. immigration policies.

Gregory S.
Me

Editor's note: The writer is an immigration lawyer.

BLAME PCs AND TV FOR THE OBESITY OUTBURST

I'm not sure I understand the connection between the fat content of food and obesity ("The list: Fat profits," Up: Aug. 18-25). Most, if not all, of the companies you mention were around before obesity became a problem. The focus should be on a sedentary life promoted by television and computers. Maybe an equivalent warning should be placed on them indicating excessive use is hazardous to your health.

Michael H. N.
T

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THE TWO-INCOME TRAP

Why Middle-Class Mothers & Fathers Are Going Broke

By Elizabeth Warren & Amelia Warren Tyagi

Basic Books • 283pp • \$26

MIDDLE CLASS AND MAXED OUT

During the boom years of the late 1990s, the banking industry and its GOP allies pushed a federal bill that would have required overextended borrowers to pay more of their debts. Instead of being able to file for Chapter 7 bankruptcy, where you can wipe out much of what you owe, more people would have had to accept the tougher Chapter 13. The bankers suggested that Americans had become a nation of mall-trolling luxury lusts drunk on credit-card spending. The legislation got pushed aside as Congress dealt with the Iraq war and sputtering economy. But the image of a *vox shopuli* endured.

Now comes a grenade of a book exquisitely lobbed at the overconsumption theory by co-authors Elizabeth Warren, a Harvard Law School professor who heads the university's Consumer Bankruptcy Project, and her daughter, Amelia Warren Tyagi, a former McKinsey consultant and Wharton MBA. *The Two-Income Trap: Why Middle-Class Mothers & Fathers Are Going Broke* draws upon 30 years of bankruptcy, U.S. Census, and Bureau of Labor Statistics data to provide a provocative reason why so many of the supposed-to-be-rich—people with college degrees, good jobs, and their own homes—have become the newly poor.

The authors say that, even though the modern two-earner family brings in 75% more inflation-adjusted income than the one-earner family of a generation ago, it actually has less discretionary income—and far more financial instability. The primary reason: The decline of public education has dramatically raised the price of housing in good school districts, prompting parents to overstretch on mortgages and bid up the price of a middle-class life.

Encouraging this trend is a deregulated lending industry, which has adopted the step-right-up antics of carnival

barkers. Thirty years ago, the typical family had no choice but to scrape together a 20% downpayment. Today, it's often 3% down, and Americans are urged by Internet lenders to take out 120% mortgages. "In their desperate rush to save their children from failing schools," the authors write, "families are literally spending themselves into bankruptcy."

At the same time, these middle-class couples are working in an era of unprecedented job insecurity, when even top-tier MBAs can easily get whacked. Salaries as well as health insurance have become a now-you-have-it, now-you-don't proposition. Since the 1970s, the risk of involuntary job loss has soared 150%, while the chance of losing health coverage has increased 49%.

These are the chief reasons, the authors say, why nearly a third of bankruptcy filers owe an entire year's worth of their salary on credit cards—something that would have been impossible a generation ago. This year alone, the lending industry filled mailboxes with 5 billion pre-approved credit-card offers totaling more than \$300,000 per family. In addition to housing and education, the authors demonstrate, families used credit cards not to service brand fever but to pay for catastrophic health problems, costly divorces, and post-layoff living expenses.

The result has been a record number of bankruptcies—1.5 million people this year. This is more than will suffer heart attacks, more than will graduate from college, and more than will be diagnosed with cancer. In fact, more children will endure their parents' bankruptcy this year than their parents' divorce. And just as the ranks of the uninsured are filling with members of the middle class,

so, too, are bankruptcy courts: Nearly 90% of those who file now qualify as middle class by virtue of income and education.

For mothers and children, the situation is even more perilous. If current trends persist, more than one of six single mothers will go bankrupt by the end of the decade. Indeed, having a child is now the single biggest predictor that a woman will end up in financial ruin. Not having a baby, on the other hand, cuts a woman's chances of ending there by 65%.

Not even a college degree offers much insurance anymore. Indeed, college-educated women are 60% more likely to end up bankrupt than less-educated women. That's because educated women often find themselves in financially ruinous divorces from which they can't ever recover economically. In the 1990s, the average newly divorced woman found 19% of her income to be discretionary. Today, that figure has fallen to 4%.

The book offers a list of prescriptions, the boldest of which are tax exemption for all savings, a school-choice voucher program that would pay the entire cost of education for a child, allowing kids to apply to any public school regardless of their Zip Code. The authors also argue

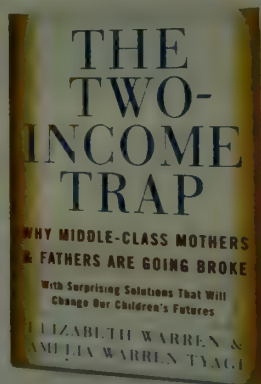
for expanded financial assistance for postsecondary and college education, as well as policies that would discourage debt.

The role of personal responsibility isn't shortchanged, either. More money, you're on your own—and yet more employees still don't contribute a dime to their 401(k)s. Here, the authors' solutions are the old standbys: Save enough cash to support you for six months. Max out on retirement savings. Scrape together that old-fashioned 20% downpayment.

But even for families that do everything right, the line between solvent and bankrupt has never been clearer. One catastrophic medical incident, one job loss, one divorce—and they never recover. Despite being courted hard by politicians, there's no such thing as a safety net for the middle class.

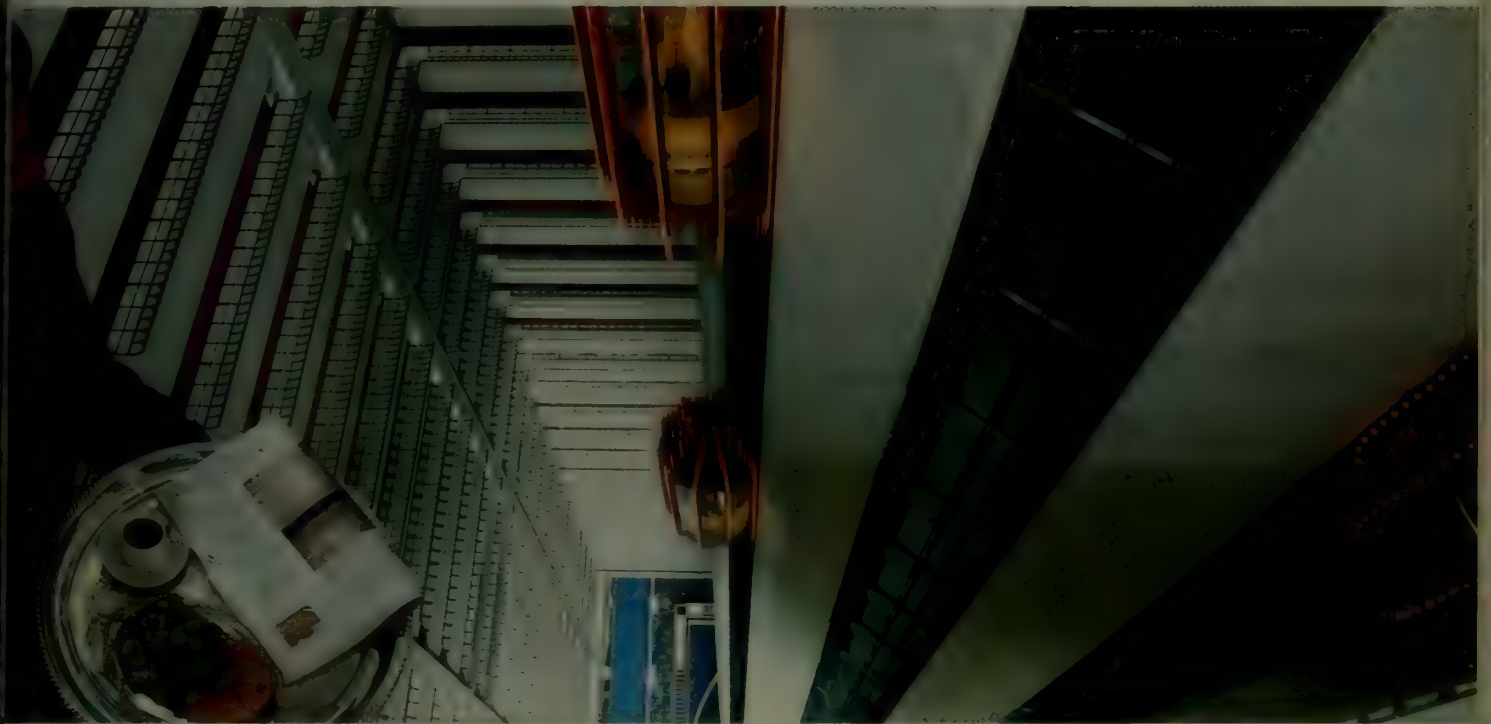
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FAMILIES LOOK AFFLUENT, THE AUTHORS WRITE UNTIL THEY SHOW UP IN BANKRUPTCY COURT

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WIRELESS TODAY

SAVING TIME, SAVING MONEY —
AND SERVING THE CUSTOMER BETTER

Here's what wireless is doing today.



ITEM: State Farm Insurance has 1,000 claims adjusters using wireless notebook computers that tap into a major carrier network enabling them to write appraisals at an auto accident scene — thereby speeding the issuance of checks to anxious and traumatized customers.

ITEM: Auditors with the State of Texas Comptroller's Office are using wireless technology to check tax records on location at business sites, saving several hours per audit, lowering costs and permitting state personnel to perform more audits every year.

ITEM: Drivers of Boston Coach cars are taking credit card payments an average of 10 times a day with an electronic signature capture device, reducing commissions to the credit card company and saving an estimated \$1 million annually.

ITEM: Aurora Health Care is using personal digital assistants with wireless capability to help control inventories of medical supplies, increasing the accuracy of reporting and freeing more of nurses' time for the actual care of patients.

The acceptance of wireless is based on a quickly maturing confluence of trends: higher bandwidth available from the investments of major carriers; more powerful devices available at more attractive prices; reasonable levels of security from industry standard offerings; and the steady advance of technical innovation.

"We're seeing a lot of adoption of certain wireless applications across

industries — field service, for example," says Phil Redman, research vice president for the mobile and wireless unit at Gartner Group. "We also see growth in logistics and shipping, scheduling and dispatch applications and more interest in field sales as well," he adds.

Gartner Group analysts expect Wi-Fi technology sales to grow more than 20 percent each year to 3.4 billion by

2005. Gartner also projects that businesses will pay less for Internet services and that wireless voice prices will begin to decline as service providers continue to compete for market share. Gartner predicts that over one million "hot spot" connection points will be in operation by the end of 2003. However, fewer than 10 percent of those will be for monthly enterprise subscribers.

WIRELESS AT WORK: WINNING WITHOUT WIRES

Wireless technology that exploits the latest carriers have to offer is beginning to show its muscle in the marketplace. The vice-president of a large executive search firm now uses his Sony Ericsson T68is photo phone to take pictures of each person he interviews. "It's a great way to enhance my records; a way to match a face with a name," says Sean Rego of the Woodmansee Group of Grandville, Ohio. Rego taps the GSM network of AT&T Wireless with his T68is, which can store up to 12 photos. Using the company's mMode Pix service, he can e-mail the photos to himself for storage on his laptop.

The T68is also supports Bluetooth short-range wireless networking, allowing Rego to use a headset with no connection to his phone, and/or connect his laptop to a personal digital assistant — all without wires, of course. The T68is is also voice-activated so he can dial phone numbers without taking his hands off the wheel while driving. "It's an incredible safety feature," he says.

Paul Belliveau, the North American president and CEO of Besam Automated Entrance Systems, which makes automatic doors used in leading retail stores, hotels, hospitals and airports, prefers a Blackberry device for sending and getting e-mail in the road. "I travel four days per week," says Belliveau, "so when I'm sitting on the tarmac or waiting in airports, I'm constantly answering e-mails." He uses the Blackberry enterprise package from AT&T Wireless, which provides him with e-mail "push" to his Blackberry 7210 and tight security features. "It's literally like sitting at your desk," he enthuses. "It probably saves me two hours a day."

Most of the major carriers have announced Wi-Fi initiatives in the past few months, including Verizon Wireless,

AT&T Wireless, Sprint and T-Mobile. "Now that there are big names behind Wi-Fi, from an enterprise customer perspective, the thinking is, it must be real," says Iain Gillott, principal of iGillott Research, the wireless analyst firm in Austin, Texas.

That information technology (IT) professionals take Wi-Fi seriously will help the carriers penetrate the market for data services. But there is still a way to go. In a recent survey of more than 1,000 enterprise IT managers, iGillott Research found that 65 percent had not yet deployed a wireless data solution. Why? Managers cited concern for security and unproven return on investment as the major factors holding them back.

In the opinion of Ian Hayes, principal of Clarity Consulting and author of "Just Enough Wireless Computing," (Prentice Hall, 2003), "The major barriers that stopped companies from moving to wireless — reliability, coverage and bandwidth, are getting better by leaps and bounds. So businesses are making a mistake if they don't start to think about wireless much more seriously. It's a real opportunity."

Gartner projects that businesses will pay less for Internet services and that wireless voice prices will begin to decline as service providers continue to compete for market share.



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PUTTING E-LIMITS ON YOUR KIDS



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Protecting children from the variety of bad influences out there on the Internet is a high priority for many parents. Not surprisingly, there is a wide range of products available to help. Large service providers—including America Online, MSN, and EarthLink—offer parental controls that will keep kids away from inappropriate Web sites. If that's not an option, there are many services, including CyberPatrol, Net Nanny, and Surf Control, each about \$40, that will do the same thing.

There's one product, though, that takes parental control in a disturbing direction. Kid Defender from Actiontec Electronics (actiontec.com) offers the traditional parental-control bells and whistles that are designed to keep children and teenagers away from nasty Web sites and dubious chat rooms. But it also gives parents the ability to spy on their kids' online activities. The program is available either as a \$79.95 purchase, including a year's use of the required service, or as a \$9.95 monthly subscription.

If you have two or more computers—which need not be linked on a home network as long as both have access to the Internet—you can monitor what your kids are doing on their computer as they do it. When they go to a Web site, the address and an image of the Web page pop up in the Kid Defender monitor window. If they visit a chat room or engage in instant messaging sessions on AOL, MSN, ICQ, or Yahoo!, the text of the conversation also shows up. To streamline this, you can set up lists of “trusted” Web sites, chat rooms, and messaging partners that will not be monitored. If you only have one computer, activity can be saved to a log for later review.

Unfortunately, Kid Defender doesn't control or monitor Web sites very well. It blocks access based on keywords, while more sophisticated programs use rules and lists compiled by people who check sites out. With Kid Defender's block-

ing on, I was able, when using the “kid” computer, to get to a raunchy site. All I saw on the “dad” monitor was a numerical Internet address and a few numbers where the screen image should have been.

Monitoring of chat rooms and instant messaging sessions worked much better, with the text of conversations showing up as it was typed. But just because technology gives you the ability to do something doesn't make it a good idea. As a parent (admittedly of grown and independent children), I believe the remote chance of kids' getting into serious trouble on the Internet is swamped by the enormous damage that will be done to your relationship when, not if, they discover that you have been spying on them. If you feel you must monitor their activity this way, at least let them know you are doing it.

Time-Scout Monitor (\$69.95) from Card Access (time-scout.com) is a much happier approach

to a simpler problem: kids spending too much time on the computer, playing video games, or watching television. It's a unit that looks a bit like a cell-phone charger connected by a six-foot cord to a display unit about the size of a pack of cards. You plug the unit into a power outlet, then plug a monitor, game console, or TV into an outlet on the box, as though it were an extension cord. Just push a plunger, and the plug is mechanically locked in place. Parents can put time in kids' accounts in 30-minute increments by swiping a bar-coded card

through a slot in the display unit. Kids spend the time in half-hour blocks by swiping their own cards. When time is running out, the children are prompted to spend more time or shut down. When time runs out, Time-Scout switches off the power.

Time-Scout works best either with a TV or monitor that does not have a detachable power cord—or with young children who haven't figured out how to game the system. Any child 8 or older could just replace the power cord that runs through the Time-Scout with another cord, circumventing the device.

Time-Scout strikes me as a better product for helping parents. It's still up to the parents to set the limits, and Time-Scout merely helps enforce them in a nonconfrontational way. Kid Defender is the high-tech version of sneaking a look at your kid's diary or listening in surreptitiously on a phone conversation. There's a remote chance it will keep a child out of trouble, but a much better one that it will cause lasting damage to your relationship. ■



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BY GARY S. BECKER

HOW TO PUT THE RIGHT CAP ON PUNITIVE DAMAGES



BALANCE:
A strict dollar limit is too arbitrary. The best method is to fix punitive damages at a certain multiple of compensatory ones

In an important but split decision, *State Farm v. Campbell*, the U.S. Supreme Court in April held that "the Due Process Clause [of the 14th Amendment] prohibits the imposition of grossly excessive or arbitrary punishments on defendants in tort cases. This was the second High Court ruling in the past few years that rightly objected to steep punitive damage awards.

Punitive damages are often added to compensatory damages awarded to victims of drunk drivers, medical malpractice, defective goods, and others who suffer because of careless or irresponsible behavior. There is no controversy about the fact that incompetent doctors, intoxicated or reckless drivers, and companies that produce dangerous and shoddy products should have to pay for the harm they cause.

But compensatory damages alone may not be enough to deter harmful actions. It is not always possible for victims to detect careless medical practices, dangerous goods, and other behavior. Moreover, some victims may be unwilling to file lawsuits because of the sizable expense in time and money, the discomfort of having to testify in court, and the uncertainty that they will win even legitimate cases. So punitive damages are often valuable; they help encourage such lawsuits and deter dangerous behavior.

Given that punitive damages are desirable, how big should they be? In his dissent in the *State Farm* case, Justice Antonin Scalia argued that the determination of punitive damages should continue to be left to individual judges and juries because the Supreme Court cannot devise a "principled application" that determines what these damages should be in different circumstances.

Unfortunately, under the present system, the principle that juries sometimes use is the depth of defendants' pockets. The Utah jury in the *State Farm* case awarded the Campbells \$2.6 million in compensatory damages and \$145 million in punitive damages. On appeal, the Utah Supreme Court reduced compensatory damages to \$1 million but allowed the punitive ones. Punitive damages, therefore, amounted to 145 times compensatory—a ratio that is far too high.

State Farm may have misled the Campbells, but its behavior was not especially reprehensible. It assured the Campbells they had no liability and no need to hire counsel to defend Curtis Campbell against charges he caused a serious auto accident. When the jury returned a large judgment against him, *State Farm* at first refused to pay but eventually relented and paid.

Excessive punitive damage awards are harmless transfers of wealth: They damage the functioning of the U.S. economy and justice system. Companies pass these costs on to consumers via higher prices. In addition, large punitive damages encourage expensive class-law firms, driven by the prospect of big agency fees, to pursue unwarranted suits.

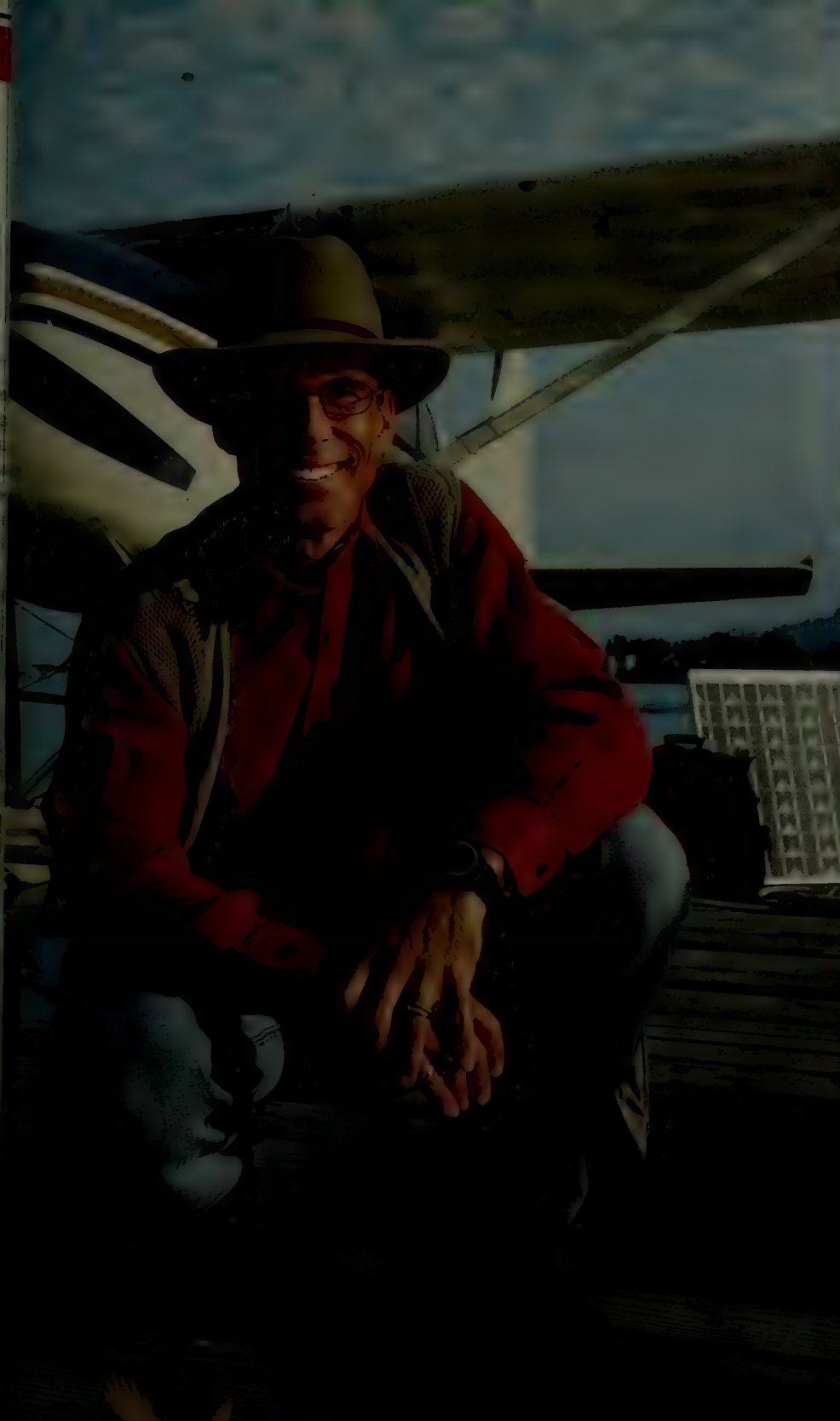
The challenge is to find rules to set punitive damages that are neither too weak nor too excessive. The Supreme Court indicated in the *State Farm* case that the ratio of punitive compensatory damages should generally be in the single digits. Antitrust laws have established this ratio at 3 to 1 in private suits against companies engaged in monopolistic business practices. Although trebling damages is a rule, it can be administered consistently with a reasonable standard to apply in tort cases as well.

Some states have already acted to limit punitive damages in different classes of law. However, they generally have imposed maximum dollar limits, as when the Florida legislature recently voted to cap physician payment in malpractice suits for noneconomic damages at \$500,000. Yet to deter harmful behavior, punitive damages should not be capped. They should be proportional to the size of compensatory damages. It makes little sense to impose similar punitive damages for behavior that causes harm of \$50,000 and \$20 million.

Strict limits on the ratio of punitive to compensatory damages would elevate the importance of accurate measurement of compensatory harm. For example, loss of life in automobile accidents caused by drunk drivers, or wrong judgments by producers of drugs that cause serious harm or death to inappropriate users, damage victims and their heirs in ways that go far beyond the loss of future earnings. Although economists have developed techniques to gauge monetary value to individuals of the loss of future activities due to wrongful deaths, courts have been reluctant to rely on them.

One might agree either with the major justices in the *State Farm* case that the 14th Amendment implies restrictions on punitive damages, or with Justice Ruth Bader Ginsburg argued in her dissent that federal courts should defer to state legislators in the setting of punitive damages. But unless more is done at the judicial or legislative levels to limit these damages, the American tort system will continue to be costly and arbitrary.

Gary S. Becker, the 1992 Nobel laureate, teaches at the University of Chicago and is a Fellow of the Hoover Institution.



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FINALLY, AN ECONOMY FIRING ON ALL CYLINDERS

Stronger demand, cheaper loans, and more profits have business spending

U.S. ECONOMY

Corporate America's reluctance to spend and hire has been the biggest drag on this lackluster recovery. Not more. Solid earnings growth, a river of cash flow, friendlier financial conditions are combining with signs of life in overall demand. It's a potent mix already starting to fuel capital spending and the economy's growth rate, the two keys to more hiring. Fresh signs of stronger growth showed up in the Commerce Dept.'s Aug. 28 update on second-quarter gross domestic product. Real GDP grew at a 3.1% annual rate, up from the 2.4% pace first reported, only reflecting upward revisions to demand from consumers, businesses, and foreigners. Moreover, the latest economic reports show that growth in the current quarter is off like a rocket: Estimates of 5% are coming commonplace.

RISING CASH FLOW FOR NONFINANCIAL CORPORATIONS



Of course, the economy has been here before. Forecasts of a growth pickup have been soundly dashed over the past two years. What's different this time is that the economy finally is firing on all cylinders. Instead of waiting on the sidelines, executives are more confident in the outlook and more willing to invest in new equipment, especially because demand is turning out to be stronger than expected. That momentum is why shocks such as the August hike in gasoline prices do not have the power to waylay the recovery that they did in previous years. Better yet, the increased willingness of executives to bet on the future means not only stronger growth and a rebound in capital spending but also suggests the job markets should finally begin to turn around, perhaps by yearend.

THE HEART

of the upswing in business spending is sharply improved financial conditions. Certainly, the more buoyant stock market has given companies access to cheaper equity financing. Plus, the risk premium that credit-market lenders demand for loans to businesses has shrunk to three-year lows. In addition, banks are friendlier. The Federal Reserve's latest survey of senior loan officers shows that the number of banks tightening their lending stan-

dards over the past three months fell to the lowest level since 1998. And for the first time since then, banks said they actually eased spreads between their loan rates and their cost of funds, citing increased competition from nonbank sources of borrowing.

But more critical than the rise in outside financing is the fact that companies are increasingly generating their own cash (charts). In its GDP report, Commerce said that second-quarter corporate profits, adjusted for inventory values and replacement-cost depreciation, soared at an annual rate of 50.8% vs. the first quarter. A new depreciation allowance from the government, along with special treatment for the airlines, boosted the gain. But the increases over the past three quarters have averaged a 23.8% rate. Profits now exceed their previous peak, reached in 1997, and corporate cash flow has surged by \$169 billion in the past two years to a record high.

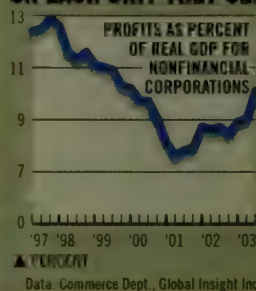
Profit margins are also rising. Profits earned by nonfinancial corporations on each unit produced last quarter rose to 10.1%, from 9% in the first quarter, the largest increase in a decade. This measure of margins is still well below its 1997 peak, but heights hit during the late-'90s boom are unlikely to be scaled again soon.

SO FAR, BETTER EARNINGS

have been primarily a story of cost-cutting. Margins improved in large part because of big gains in productivity, which cut the labor cost of producing each unit of output (page 32). For example, productivity over the past year was up about 4%, allowing unit labor costs to fall about 1%. Even with prices up a mere 0.9%, the profit margin on a unit of output increased significantly. That's one reason why companies have been able to lift overall profits even as revenue growth has been tepid.

Now the story of stronger profits is beginning a new chapter. Past margin improvement is starting to combine with stronger demand. Revenue growth will clearly increase in the second half, thanks to a spurt in consumer demand. Real household spending in July jumped 0.6%. Lifts from tax cuts and refi cashouts, plus strong weekly reports on back-to-school sales and car buying in August, suggest real outlays could rise

BUSINESSES EARN MORE ON EACH UNIT THEY SELL



5% this quarter. And fatter margins mean that a greater percentage of that extra revenue will fall straight to the bottom line.

Finally, earnings will benefit from the moves by businesses to eliminate their excess capacity. The overhang of production facilities was one trigger of the last recession, and businesses spent most of this recovery paring down their capacity. The resulting drop in fixed costs will lift profits as demand strengthens.

BUT AS THEY MOTHBALL older machinery, businesses finally seem willing to buy new more efficient machinery. That's because companies recognize that to keep the productivity advances coming, they must continue to invest in the future.

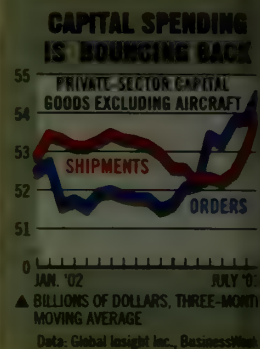
The latest GDP data show that outlays for new equipment rose 8.2% last quarter, the largest quarterly advance in three years. That's also true even before adjusting for falling tech prices. Overall dollar purchases of tech equipment led the way last quarter, also growing at the strongest pace in three years (page 36). In particular, business outlays for computers and peripherals, unadjusted for prices, soared 37.3%—the biggest quarterly increase since 1995.

It's no flash in the pan. Monthly data on orders and shipments of capital goods show continued gains in July that suggest an even faster pace of overall equipment spending this quarter (chart). Orders for capital

goods, excluding the volatile aircraft industry, have been trending higher since the end of last year. In the past three months, shipments of capital goods have taken off, growing 2.9% in both June and July, the largest two-month rise in more than a decade.

Another key driver in the business-sector rebound will be the need to rebuild depleted inventories, a trend that is especially noticeable in the manufacturing sector. From April to July, shipments of durable goods rose 4.6%, but inventories fell 2%. That's one reason factory activity is ramping up, as seen in the steady rise in the index of industrial activity compiled by the Institute for Supply Management. The index posted a fourth consecutive rise in August, to 54.7%, a level that the ISM says maintained, is consistent with overall economic growth of 4.3%.

The last time real GDP averaged growth above 4% for at least two quarters was back in 2000. But thanks to accommodative financial conditions and a better production outlook, businesses are now ready to add their considerable weight to the recovery. Their participation means that growth will be stronger and more self-sustaining.



SOUTHEAST ASIA

LOOK FOR A DOUBLE-DIGIT TURNAROUND

Several Southeast Asian economies got sick during the first half of the year. The diagnosis was a nasty combination of a weak U.S. economy limiting export growth and SARS' damping down of domestic demand. Now, the region is poised for a healthy second half.

Most of the area's second-quarter gross domestic product figures are out. Singapore's economy contracted at an annual rate of 11.4%, Taiwan GDP shrank for the first time in six quarters, and the Philippine economy posted very weak growth of just 0.4%.

Southeast Asia is expected to outperform the rest of world over the remainder of the year. Singa-

pore's GDP is forecast to jump 15% in the second half, as is Hong Kong's economy (table). Exports of tech gear, a key part of the region's economy, are set to take off. U.S. business investment is

rebounding, and a big part of that spending will be in high tech. The U.S. is a huge market for the region: Over 9% of U.S. goods imports come from Southeast Asia.

In addition, demand for high-tech gear by the larger Asian countries, such as China

and South Korea, is set to surge higher. Research company Gartner Inc. expects Asia-Pacific semiconductor sales to hit \$67 billion this year and jump by over 20% next year.

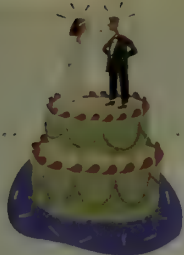
To ensure a strong recovery, though, domestic demand will have to rebound as well. There are signs that consumer spending and tourism are recovering from the severe acute respiratory syndrome outbreak of earlier this year. Hotel occupancy in Hong Kong hit 60% in July, from 30% in June. But countries such as the Philippines, where exports account for over 40% of GDP, need to do more to build up their domestic economies.

Any outlook comes with a caveat, however. An attempted military coup in the Philippines and an August car bombing in Indonesia highlight the region's vulnerability to terrorism. Further attacks could scare off both tourists and consumers, to say nothing of investors.

By James Mehring in New York

TALES OF TWO HALVES

	2003 REAL GDP*	
	FIRST HALF	SECOND HALF*
HONG KONG	-7.6%	15.0%
INDONESIA	6.0	4.0
MALAYSIA	4.8	5.5
PHILIPPINES	-0.9	6.8
SINGAPORE	-15.0	15.0
TAIWAN	-3.8	12.5
THAILAND	3.1	4.5
PERCENT CHANGE FROM PREVIOUS PERIOD, AT ANNUAL RATE†		
Data: JP Morgan Chase		
*FORECAST		



Richard L. Kauffman, Vice Chairman of Institutional Securities

Assets & liabilities:

A mismatch not made in heaven.

If interest rates and stock market returns remain low – and the question is how low – there's a big problem looming for the global economy. Without resorting to melodrama, this apparently prosaic issue could represent one of the biggest policy challenges of the next generation.

The Fed and other central banks have lowered interest rates to encourage consumers to spend and businesses to invest to stimulate the economy. But we must look at the other side of the ledger: as rates go down, the value of fixed liabilities goes up. For some years now, investors have increased their debt load assuming that their investment returns would provide the necessary funds to repay the loans. Put differently, you are going to sleep a lot easier if you owe \$10,000 in ten years if you are investing your money at 10% than if you are earning 2%.

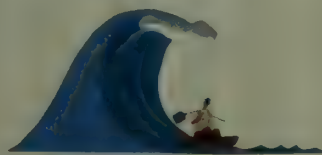


The combination of low interest rates and low stock market returns creates a double whammy: the degree of liabilities goes up and the value of assets is inadequate to generate enough returns to service the liabilities. Liabilities for our society are everywhere: people need to retire, to put their children through school, to purchase homes. And then there are the liabilities that are held by banks and insurance companies, by governments and by individual investors, such as margin and mortgage debt.

Bluntly stated, if the current combination of low interest rates and low returns continues, there's a tidal wave of asset-liability mismatch headed our way. In the US, many households relied on 401(k) stock accounts and rising home prices as a source of savings and relied on these savings to

take on increasing amounts of debt. Credit card debt has tripled in the last decade, now amounting to over 15% of household income. With this level of debt and a reduction in stock prices, it is no wonder that observers question whether consumers can spend the economy out of recession.

How to get out of the asset-liability "mismatch"? The best answer, of course, is if government stimulus succeeds and returns increase. But we must ask the question, what if such medicine fails to work? There are other answers, some of which are not pretty: *Retire later*. Or aren't people entitled to retire, or must they work until death? *Save more*. In the



short term, increases in savings will come from reducing consumption and with it economic growth. But will we be the Depression Generation Redux telling our grandchildren to be thrifty? Or *greater government intervention*. If markets don't seem to work and individuals can't save enough, will government enforce savings? And how will that be funded?

Asset-liability mismatch. It is a prosaic term. But it could be a big problem you'll be hearing more about.

Richard L. Kauffman
Vice Chairman of Institutional Securities

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STILL GETTING STRONGER



Tech-driven productivity is powering profits, stock prices—and now, spending

It has been a long time since prospects for the U.S. economy looked this good. Profits are up, capital spending is rising, and inflation remains under control. Even ailing manufacturers are showing signs of life, with the Institute for Supply Management reporting on Sept. 2 an upswing in factory orders and production. And following the second quarter's surprisingly strong 3.1% gain in gross domestic product, economists are scrambling to revise their second-half forecast skyward. Many now think

growth could finish the year at a healthy 4% clip.

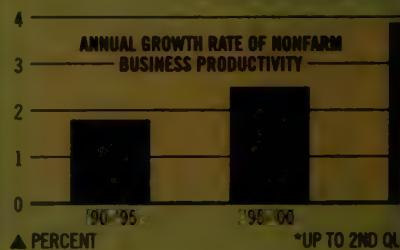
But the most important news is the continuing surge in productivity. The latest numbers from the Bureau of Labor Statistics, released on Sept. 4, are expected to show productivity growth for first-half 2003 at above 4%, exceeding expectations. Each additional quarter that it stays high helps convince economists and business executives that an era of strong productivity growth is here to stay. Indeed, some economists think the U.S. can again sustain productivity growth as high or higher than the nearly 3% average of the economic Golden Age, from 1948 to 1973. "The U.S. economy is in the midst of an historic productivity boom," says John Lipsky, chief economist at J.P. Morgan Securities Inc.

That's of more than just academic interest. The continued surge in productivity is a key reason why profits have strengthened considerably in recent quarters even as growth remained tepid. Even now, pricing power remains non-

existent in many sectors, and capacity excessive. Yet ever-improving productivity has enabled companies to squeeze costs and rebuild their bottom lines.

All that is combining to provide a powerful payoff. As tax cuts and monetary stimulus start to work their magic on the economy and give a boost to demand, investors and executives across Corporate America are finally starting to crawl out of the psychological burrow many have holed up in for the last few years. With profits strong and growth beckoning, stocks are up, and newly optimistic execs are loosening purse strings.

PRODUCTIVITY IS RUNNING HOT...



Data: Bureau of Labor Statistics



pend on technology again (page 36). One of that would be happening but the amazing resilience of U.S. productivity. What makes it most surprising is that many economists had predicted the opposite: Its growth was poised to slow after the Roaring '90s. The downturn itself was expected to dampen productivity after 2000. And security spending after September 11 was expected to divert resources into essential but nonproductive uses. Plus, the drop in business investment in the last couple of years supposedly dented productivity.

So why has it exceeded even optimistic expectations? For one thing, information technology has proven even more potent than economists believed. Many companies are only now making full use of computers and software bought during the tech-spending boom that ended in 2000. "It takes one, two, three years to get down the learning curve and figure out new ways to use it," says General Electric Co. Chairman and CEO Jeffrey R. Immelt. Others, such as Cisco Systems Inc. Chief Executive John Chambers, put the learning curve at five to seven years—meaning the

U.S. could benefit for years to come.

General Motors Corp. was long ridiculed for blowing cash on ineffective factory automation. GM is finally getting the hang of technology. Heavy investment to modernize its 17 North American stamping plants raised stamped pieces per labor hour 13% in 2002 alone, estimates manufacturing consultant Harbour & Associates Inc. GM has also cut its North American engineering costs 44% while working on a third more products. The savings, GM claims, are in the billions of dollars.

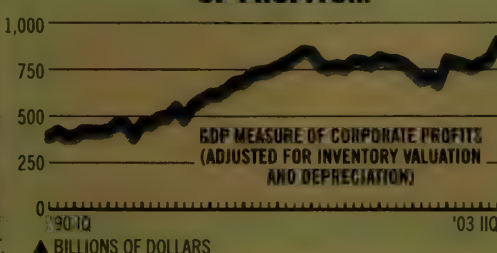
Many companies have also gotten

...AND THE ECONOMY IS REBOUNDED...



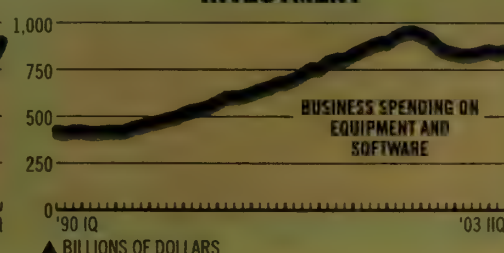
Data: Commerce Dept., BW forecast

...WHICH IS PROPPING UP PROFITS...



Data: Commerce Dept.

...AND SPURRING BUSINESS INVESTMENT



Data: Commerce Dept.

smarter about how they spend on tech. Merrill Lynch & Co.'s Merrill Online trading platform was at first seen as a threat by its thundering herd of financial advisers, and many customers preferred to consult their advisers instead of investing on their own online. Now, Merrill is trying again, investing \$1 billion in cooperation with Thomson Financial on "wealth management workstations" intended to strengthen the bond between advisers and clients. "We will save tens of millions of dollars annually," says Byron Vielehr, chief technology officer of Merrill's global private client group.

The need to collaborate on big, in-

dustrywide projects—which can often take time to unfold—also explains why more gains are flowing in now. Procter & Gamble Co. Chief Information Officer Stephen N. David expects that a new, industrywide data-sharing project called UCCnet Inc. will enable P&G to save an immediate \$40 million a year or more. Five years in the making, UCCnet will cut the volume of products P&G ships to stores and then gets back unsold. And as the entire industry embraces UCCnet, David expects even bigger gains.

Yet technology explains only part of the productivity boom. Economists also failed to appreciate how tighter man-

agement could contribute to efficiency gains year after year. Practices such as benchmarking performance against comparable companies, outsourcing, use of temporary workers, and business process redesign have not only raised the level of productivity but raised the rate at which companies improve. Companies are also quicker to resort to layoffs. Painful though that might be, it helps avoid the big drops in productivity that come from having far too big a workforce when orders dry up.

How high can productivity grow? From 1948 to 1973, it averaged a little less than 3% a year. Then

COMMENTARY

By Richard S. Dunham

THE ADMINISTRATION'S BLUE-COLLAR BLUES

The candidate stood before a group of Ohio construction workers and dished out red-meat rhetoric for Labor Day. "There's a problem with the manufacturing sector," he said. "We've lost thousands of jobs... manufacturing must do better." Democrat Dick Gephardt down at the union hall? Nope. It was George W. Bush, who has presided over the biggest loss of manufacturing jobs since Herbert Hoover.

If the President is sounding themes of the populist Left these days, there's good reason. He's feeling the heat from a huge loss of jobs. Since Bush took office, 2.5 million U.S. factory jobs—16% of the total—have been lost. Although such jobs have been vanishing for years, "this is clearly the worst we've seen," says William A. Strauss, a senior economist at the Federal Reserve Bank of Chicago.

The manufacturing morass is setting off a political scramble that stretches from that muddy construction site in Richfield, Ohio, all the way to Beijing. That's where Bush dispatched Treasury Secretary John W. Snow for currency talks designed to mollify U.S. execs and blue-collar voters angered at the loss of manufacturing jobs to China.

Critics say China, by pegging the yuan to the dollar at an artificially low rate, is flooding the U.S. with cheap goods. While Administration officials believe the threat is exaggerated, they don't want to appear complacent. "We

have to recognize the domestic political story line," says a top Bush aide. "We have to address it." Snow left Beijing on Sept. 3 without a deal but expressed optimism that the currency will eventually be allowed to float. Asian economists say the gambit was doomed. "No [Chinese] leaders want to be seen as giving in to foreign pressure," says Citigroup's Yiping Huang in Hong Kong.

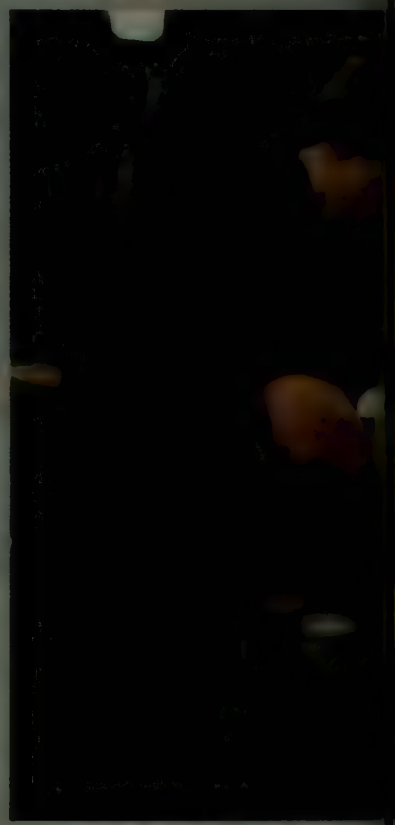
Bush is hoping for more tangible results at home. He will soon name a new Commerce Dept. manufacturing czar, and on Sept. 15, Commerce Secretary Donald L. Evans is slated to unfurl a "Manufacturing Initiative" in Detroit. The package recycles Bush proposals such as legal reform and energy legislation. But it also includes a push for tougher enforcement of trade pacts, including an assault on dumping and export subsidies. *BusinessWeek* has learned that Evans will propose making it easier for U.S. businesses to file antidumping and subsidy cases by requiring less proof of damage before a complaint can be filed. "We need to be more proactive in looking at allegations [of cheating]... instead of waiting until an injury happens," says Commerce Under Secretary for International Trade Grant D. Aldonas.

Still, economists say few of these measures are likely to have much im-

GRAYOLA FACTORY
Rising productivity translates into fewer factory jobs. That could present a problem for Bush in the campaign

pact on the system in factory jobs. Rising productivity means manufacturers can maintain the level of gross domestic product with about 16% fewer workers. And even if the yuan were to float its currency likely would do no more than slow the export to China.

Manufacturing's woes present a political challenge for Bush because downturn is concentrated in the ground states of Pennsylvania, Michigan, Minnesota, Wisconsin, and West Virginia. The decline in textile jobs also threatens Bush's solid grip on Georgia and



ed to under 1.5% annually from 1995. Productivity rebounded 5% in the next five years and has led to 3.9% annually since. So long-term estimates are being ratcheted up. Few think the first-half rate of 3% is sustainable, the Federal Reserve is implicitly predicting long-run activity growth of 2.5% to 3%. J.P. Morgan senior economist James Glass estimates it at about 3%.

That means that over the longer term, the economy is capable of higher growth without inflation than many economists have predicted. If long-term activity is now closer to 3% and the labor force is growing at 1% a year, the economy can grow steadily at roughly 4%. There is a downside, of course. While

it's good for the economy as a whole, rising productivity accounts for the jobless recovery the U.S. has seen so far—and will continue to see for some time. Since rising productivity lets companies meet new demand without adding workers, GDP will have to grow at a higher rate than in the past before new jobs are created. Most economists think it will take a long period of growth above 4% for the unemployment rate, now over 6%, to fall back to 5% or so.

And some economists continue to fear that the latest signs of a productivity-led economic recovery could be another false dawn. Columbia University economist Edmund S. Phelps worries that in their cost-cutting zeal, companies may

have carved too deeply into research and development.

He may be right. But many companies with a reputation for ruthless cost-cutting, such as Wal-Mart Stores Inc., continue to invest for the future. Says Wal-Mart Chief Information Officer Linda Dillman: "There are a lot of CIOs right now who are trying to defend their existence.... That's not a question I ever get. It's more a battle over what are the long list of things we think we can go make a difference with."

American business is getting its animal spirits back. And the productivity surprise has a lot to do with it.

By Peter Coy in New York, with Timothy J. Mullaney in New York, and bureau reports



"He has done absolutely nothing up to the promises he made in the manufacturing sector, particularly in the textile industry," says Willis C. Moore III, executive vice-president of textile manufacturer in Greensboro, N.C. "He won't get my vote next time."

Democratic rivals sense an opening. While their approaches vary, they favor far more activist federalism. Senator Joseph I. Lieberman would use the tax code to reward manufacturers based on the share of production that remains in the country. Former Vermont Governor Howard Dean would reopen trade pacts on environmental and labor con-

ditions and a national minimum wage that could raise the cost of foreign goods.

While most execs remain big fans of Bushonomics, many fret about manufacturing's plight. "If we don't do something relatively quickly, we aren't going to have a whole lot of domestic manufacturing left," says John P. Hiler, president of Hiler Industries Inc., a LaPorte (Ind.) metal-casting company. That's why politicians of all stripes will extol their industrial strategies from here to Election Day—even as U.S. factory jobs continue their downward spiral.

With Paul Magnusson in Washington, Dexter Roberts in Beijing, Mark Clifford in Hong Kong, Joseph Weber in Chicago, and Dean Foust in Atlanta



THE POLITICS OF JOBS

Here's where President Bush and his Democratic rivals stand on the decline of manufacturing jobs in the U.S.:

PRESIDENT BUSH

- Bush says he'll appoint a manufacturing czar to help create jobs
- Treasury Secretary John Snow wants China to float its currency
- Tax-rate cuts should prompt manufacturers to expand investments
- Steel and agriculture would benefit from new tariffs on imports

THE DEMOCRATS

- Connecticut Senator Joseph Lieberman favors new tax credits to reward U.S. companies for keeping plants at home
- Massachusetts Senator John Kerry proposes a Clintonesque approach based on job training
- Former Vermont Governor Howard Dean would reopen old trade pacts to win new concessions from America's partners
- Missouri Representative Richard Gephardt wants the World Trade Organization to enforce a global minimum wage



TECHNOLOGY

IS THE SPENDING DROUGHT OVER AT LAST?

Corporate IT outlays are at their strongest since early 2000

When Cisco Systems Chief Executive John T. Chambers told Wall Street analysts a month ago to look for revenue growth of 3% after three quarterly declines, he couched it in tortured, Alan Greenspan-like prose. "We are starting to see some very early signs that could be interpreted, with the appropriate caveats, as cautiously optimistic," he said.

Now, the limb Chambers was standing on looks a lot sturdier. According to the Commerce Dept., second-quarter spending on information-processing gear rose 7.6% over the previous year, the fastest growth since late 2000. With the second half expected to remain strong, growth for the full year should come in at about 6%, according to Precursor Group, an investment-research firm. And next year could approach 9%.

Has the long-awaited tech rebound arrived at last? It certainly seems that way. Corporate profits are up and chief information officers report higher spending. Indeed, there appears to be a major psychological shift going on throughout the business world as signs of a strengthening economy abound and the stock market marches higher. Dell, IBM, Mi-

crosoft, and Intel all reported double-digit revenue gains in the second quarter, while Chambers told analysts on Sept. 3 that August sales exceeded expectations. Other tech companies expect similar jumps. "I saw 10 customers on a trip in August, and every one of them said business was improving," says Michael Marks, CEO of contract manufacturer Flextronics International Ltd. "If September and October are strong, it's 'let the good times roll' again."

Well, not quite. Don't expect a return to the boom times, but there's little doubt that a confluence of factors is driving a nascent recovery. While consumer demand for PCs and digital cameras has been brisk for a long time, now corporate buyers are beginning to weigh in. Some companies are once again replacing aging PCs and other equipment with new, lower-priced models. Sales of \$3,000 servers based on the free Linux operating software, for instance, grew 40% in the second quarter as corporate buyers continued to move

SERVERS ARE MOVING

IBM, Dell, Intel, and Microsoft saw double-digit second-quarter growth

ON THE FLOOR OF BIG BLUE'S POUGHKEEPSIE (N.Y.) FACTORY

away from Unix-based models that typically cost around \$25,000. The overall server business grew in the quarter for the first time in nearly two years. Chip sales are also on a roll, growing 10.5% in July, to \$12.5 billion. Chip plants are now running at 94% of capacity.

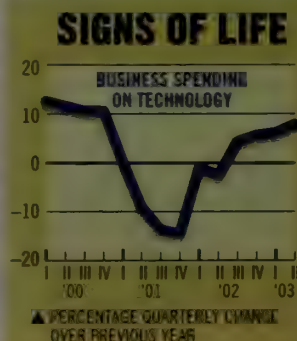
Even battered segments are showing signs of life. While phone companies' budgets called for spending cuts of 10% in 2003, cheaper broadband offerings from SBC Communications and Verizon Communications have led to higher sales. Net-access gear. Sales are also up. Wireless networks and "voice-over-IP" phones that let companies cut phone bills by using the Web. On Sept. 3, for instance, Nortel Networks landed a \$1 billion wireless contract with Verizon. At the Defense Dept. plans to spend \$800 million in the next two years to build a high-speed network called GIG-BE. While mega-deals for corporate software have been rare, SAP recently signed a \$35 million pact with soapmaker Dial Corp. "[Customers] seem more optimistic," says SAP America Inc. CEO William R. McDermott. "It's the first signal that things are about to move."

For now, much of the spending seen to be coming from smaller companies according to execs at Cisco, Dell, and SAP. Why is the little guy spending? Smaller companies, which typically move faster than larger ones, are in stronger enough shape now to take advantage of newer, lower-cost technologies for the first time in years. Lamps Plus in Chatsworth, Calif., for example, is putting e-commerce kiosks in each of its 44 stores and has hiked its tech spending 20% to \$2 million, over the past two years.

Given the budding upturn, will all the cautious talk from high-tech's CEOs end soon? Maybe not. They've been burnt before, as Cisco's Chambers knows too well. "There are strong incentives

to wait before you take your foot off the brake, much less put it on the gas pedal," he says. That's one reason why this tech recovery, while welcome, isn't likely to break speed records.

By Peter Burrows
San Mateo, Calif., and
Steve Hamm in New York, and bureau reporters



*There I was face to face
with a Malaysian tiger*

prawn in garlic and butter sauce.



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COMMENTARY

By Rich Miller

THE PRICE OF LOST CREDIBILITY

After being revered for years as a monetary maestro, Federal Reserve Chairman Alan Greenspan now finds himself the subject of derision and doubt. Stung by wild swings in bond prices, investors blame the Fed chief for misleading the markets about the threat of deflation and the central bank's likely response to it. The result has been a loss of Fed credibility. And that's making it hard for the central bank to convince investors that the improving economy won't bring tighter credit and faster inflation.

In an effort to set things straight, Greenspan used the Kansas City Fed's annual end-of-summer meeting of monetary mavens in Jackson Hole, Wyo., to provide his first public exposition of his brand of monetary policy. Unfortunately, his explanation fell short, raising as many questions as it answered. It also sowed confusion about one of the prime topics preoccupying the bond market: Just when will the Fed start raising rates?

Greenspan dubbed his strategy a "risk-management approach" that involves weighing the probabilities of various economic outcomes and acting accordingly. He tries to minimize the risk of particularly damaging developments, such as deflation, even if he thinks such dangers are not likely to occur. "Such a cost-benefit analysis is an ongoing part of monetary policy decision-making," he said.

That's the approach the Fed followed when Russia defaulted on its debt in 1998. Although the Fed believed the U.S. economy would weather that crisis, it cut interest rates anyway in case it was wrong.

The Fed chief's remarks, which had little impact on the market, went straight to the heart of an age-old debate in monetary policy. Should central bankers set interest rates using strict policy rules, such as those that

link rate changes to the ups and downs of inflation and unemployment? Or should they use discretion?

Not surprisingly, Greenspan favors more flexibility. And on its face, the strategy makes sense. Monetary policy "is like driving to Jackson Hole," says economist Michael Mussa. "You want to follow the road, but if you meet a herd of bison on the way, you stop."

But in practice, carrying out such a flexible policy is difficult. Greenspan says a risk-management strategy is necessary because the economic and financial outlook is fraught with uncertainty. Trouble is, if the Fed doesn't clearly explain how it sees the risks, its own policy response can add to markets' uncertainty. That's what happened lately as investors have struggled to figure out just how far the Fed would go to minimize the re-

Investors blame the Fed for misleading markets about the threat of deflation. Now Greenspan needs to explain his strategy better

CRYPTIC: GREENSPAN

But after years of playing the role of cryptic central banker, he has a ways to go before earning the title of communicator-in-chief.

mote risk of a deflationary downturn.

Nor do the markets have a clear sense of what the risk-driven strategy means for rates in the coming months. If the Fed cut rates so sharply in part because of deflationary risks, what will it do now that a strengthening economy has all but wiped out that danger and has started to fan talk of inflation?

Greenspan has sought to convince the markets that he'll stand pat for quite a while, even as the economy picks up steam. But investors, aware of the premium Greenspan places on flexibility, are skeptical. Already, they are driving up long-term rates, partly in expectation the Fed will raise short rates in the spring.

This is not the first time the Fed has faced questions about when to reverse rate cuts. After cut rates in the Russian debt default, economist Alan H. Meltzer says, it waited too long to reverse course in '99. The economy built up such a head of steam that it took much higher rates and a recession to cool it off. Some economists fear that in promising to keep rates low for a while, Greenspan will either box the Fed into making the same mistake again, or do further damage to its credibility by reversing course.

To his credit, Greenspan is trying to explain his version of monetary policy.

Fed-watcher Miller attended the Jackson Hole, Wyo., meeting





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INVESTIGATIONS

HOW TO MAKE THE SEC LOOK STODGY

Will Spitzer's mutual-fund probe get the feds moving faster?

Eliot Spitzer, New York State's attorney general, is at it again. Like Batman out to save a sordid Gotham City, he continues to pursue and torment the professional investment community, vowing to end everything from fraud to conflicts of interest that affect investors. Now, he's taking on the mutual-fund industry.

On Sept. 3, in an energy-infused press conference, Spitzer said "illegal trading schemes" allowed at least one hedge fund to buy mutual-fund shares at prices that were not available to most other investors. The attorney general announced a \$40 million settlement with the hedge fund, Canary Capital Partners LLC, and its managing principal, Edward J. Stern. Stern, the son of real estate magnate and billionaire philanthropist Leonard Stern, did not admit or deny wrongdoing. Spitzer continues to probe mutual funds on the other side of its trades. "It's the first shock to the fund industry in 60-some years," says John Collins, a spokesman for the Investment Company

Institute, a Washington (D.C.) fund industry trade group. "If these charges prove true, there has been a breach of law that cuts close to the heart of what protects all mutual-fund shareholders."

But while Spitzer continues to grab headlines, many wonder: Where is the Securities & Exchange Commission? The SEC has made clear it wants mutual funds to give investors more information about fees, portfolio turnover rates, revenue-sharing payments to brokerage firms, and the compensation of portfolio managers. In January it proposed some new regulations, and in June it put out a 120-page report on the industry's practices. In late July, the House Financial Services Committee passed a bill that would make most of those changes and more. Now, expectations are high that Spitzer's big splash will spur the SEC to adopt those measures quickly, and perhaps more.

But if greater transparency is always helpful, that alone is unlikely to stop the sorts of illegal practices Spitzer al-

leges. And probing mutual funds has been a top priority at the SEC, although its caseload is up. Says Mercer Bull, a law professor at the University of Mississippi and founder of Fund Democracy, a mutual-fund advocate: "The failure has been on the enforcement side. The SEC has done nothing to suggest that it really means business."

Spitzer's case against Canary was based on a tip that came his way—he was able to move fast because he faces fewer procedural hurdles than the SEC does. "Spitzer continues to target the SEC in major new areas of investigation.... He's making an obvious effort to beat the SEC to the prosecutive deadline," says Seth T. Taube, a former SEC prosecutor who now chairs the securities litigation practice of McCarthy English, a Newark (N.J.) law firm.

The SEC applauded Spitzer's score—but wondered why he pursued the case without clueing them in. "We've been looking at mutual-fund sales practices for a number of months," says one official. "Collectively, we have limited resources in which to look under every rock; perhaps we could be more efficient with a little more coordination."

Spitzer's complaint against Canary Capital should put to rest any idea that the mutual-fund industry is a pristine, ethical world in which little watchdogging is needed. The complaint alleges that Canary was allowed to trade certain mutual funds after the market closed, exploiting market swings. "Late t-

ANATOMY OF A FRAUD

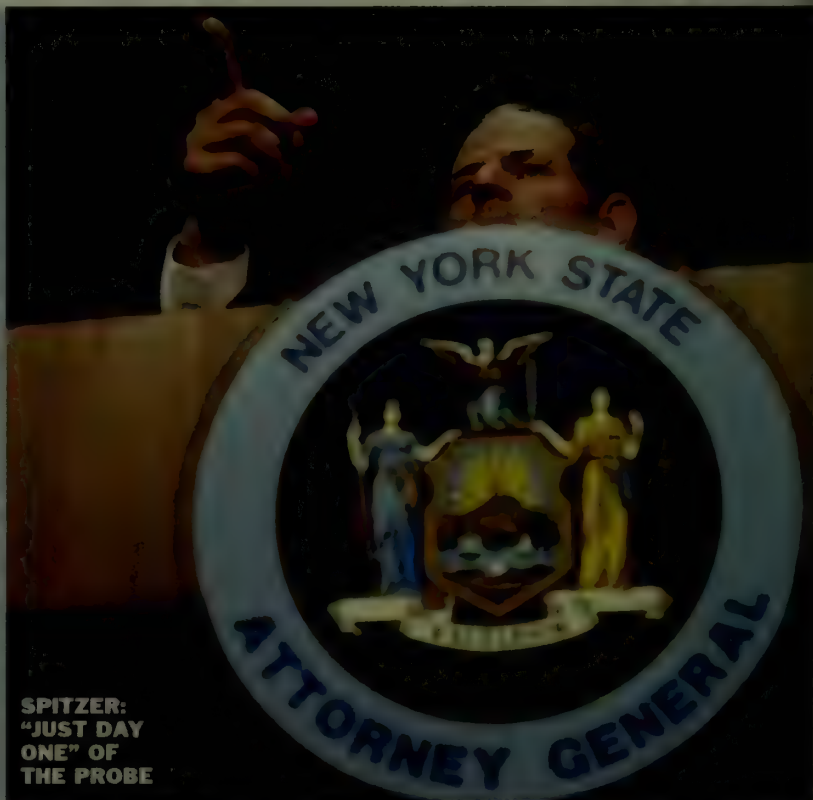
In exchange for large investments in fee-generating funds, mutual-fund companies allowed hedge funds to:

- ▶ Trade mutual-fund shares illegally on after-hours, market-moving news
- ▶ Get in and out of mutual-fund shares throughout the trading day, called timing
- ▶ Profit from artificially low share prices the fund companies maintained in their own funds at the market's close

But that meant big costs for investors:

- ▶ Timing created transaction costs that were passed on to long-term investors
- ▶ Gains were limited since managers held more cash to pay profits to the hedge funds
- ▶ Timing forced funds to use costly hedges to keep volatility down
- ▶ Redemption fees for timers were waived, depriving the mutual funds of revenue

Data: New York State Attorney General's Office

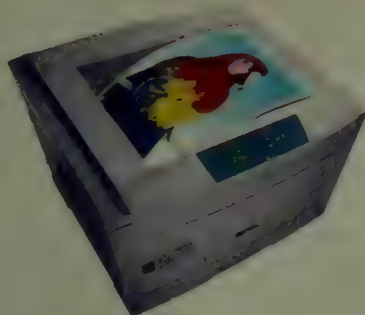


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ing," as it's sometimes called, is prohibited by New York State's Martin Act and SEC regulations because it allows select investors to take advantage of events that occur after the market has closed and are not figured into the funds' net asset value (NAV). Spitzer described the practice as "being permitted to bet on yesterday's horse race."

The hedge fund was also allowed to engage in "timing" mutual funds—doing short-term "in and out" trades, based on previous NAVs. This harms buy-and-hold investors. Spitzer called this type of trading "akin to playing a casino with loaded dice."

What was in it for the mutual funds? Plenty. Canary plowed millions in assets into the mutual funds in exchange for the right to engage in timing. The hedge fund also offered to pay higher management fees than other customers. And it invested in accounts called "sticky assets"—typically long-term investments in other financial vehicles managed by the mutual fund, such as bond funds, "that assured a steady flow of fees to the manager," according to the complaint.

Mutual-fund firms named in Spitzer's complaint are among some of the most respected: the Bank of America's Nations Funds, Strong Capital Management, Bank One, and Janus Group. All say they are cooperating fully with the AG's office. Says Russel Kinnel, Morningstar's director of fund analysis: "One of the reasons that funds are so popular is the perception that they're very ethical—they supposedly treat the little guy like the big guy. But clearly, they haven't done that here."

Ironically, hedge funds have taken most of the heat from regulators and in the press of late. Some insiders say that to take the focus off them, hedge-fund managers have been "ratting out" their mutual-fund brethren. "Hardly anyone has a clue about all the games mutual funds play—it's all about the big bad hedge funds," says one manager.

Spitzer would not comment on any pending settlement with the mutual-fund firms and no charges have been filed. But Canary will be required to return \$30 million in profits reaped from illegal trading and pay an additional \$10 million fine. Moreover, the AG says this issue is far from over: "There are many other institutions involved in timing. It's just Day One of this investigation." Given Spitzer's track record, it could be remembered as D-Day for mutual-fund companies.

By Marcia Vickers, with Mara Der Hovanesian in New York and Amy Borrus in Washington

ANGLING FOR THE REALLY BIG FISH

When W.A. Drew Edmondson filed felony charges against WorldCom and its former CEO, Bernard J. Ebbers, on Aug. 27, the Oklahoma Attorney General seemed to be saying: If the feds won't step up, I will. Edmondson is tapping into rising public resentment that, two years after the start of a series of corporate scandals that shocked the nation, only one CEO has gone to jail: ImClone Systems Inc. founder Samuel Waksal.

Meanwhile, the former heads of Enron Corp. and WorldCom, the two biggest blowups, remain free. Although investors lost billions, the feds have yet to charge Ebbers—who has maintained his innocence since the beginning—or former Enron Chiefs Kenneth L. Lay and Jeffrey K. Skilling, who also say they've done nothing wrong. "The primary reason we decided to proceed against WorldCom was my disappointment with the sanctions that have been leveled to date at

the federal level," says Edmondson.

Adding to the perception that he is most responsible for hurting investors are untouchable, federal prosecutors trained their early fire on what are as lesser crimes. Take ImClone. V. serving a sentence of seven years and three months for insider trading. domestic diva Martha Stewart, who sold 3,928 ImClone shares at a suspiciously opportune moment, is expected to go to trial in January on charges of obstructing justice. Stewart, who says she is innocent of any wrongdoing, also faces charges from the Securities & Exchange Commission on charges of insider trading. Says Edmondson: "She didn't damage individual investors the way people have been damaged by Enron and WorldCom."

Have the feds been sitting on their hands? The SEC and Justice Dept. say that they are moving as quickly as they can. And there has been progress

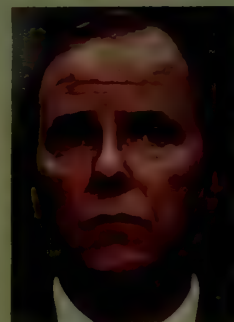


BERNARD EBBERS
WorldCom

It's not clear that the feds will ever be able to bring charges against

Ebbers, who is still under investigation by the U.S. Attorney for the Southern District of New York. True, the feds have gone hard after Scott Sullivan, Ebbers' former chief financial officer. The latter has been charged with lying to obtain \$4.25 billion in loans from company bankers, securities fraud, and filing false financial statements—allegations to which he has pleaded not guilty. If Sullivan is convicted when he goes to trial next February, he could implicate Ebbers in hopes of reducing any possible sentence or fine. Four other executives, who have pleaded guilty and are cooperating with Justice, may possibly do the same. But for now, no smoking gun tying Ebbers to the alleged fraud has surfaced publicly. "Absent Sullivan or someone immediately beneath him, it will be difficult to convict Mr. Ebbers," says Columbia Law School

professor John C. Coffee Jr. "You can't show he knew this was going on, but it's not easy in the case of the CFO, because he has to sign off on it. It could be that he was so insulated that he won't be brought on charges."



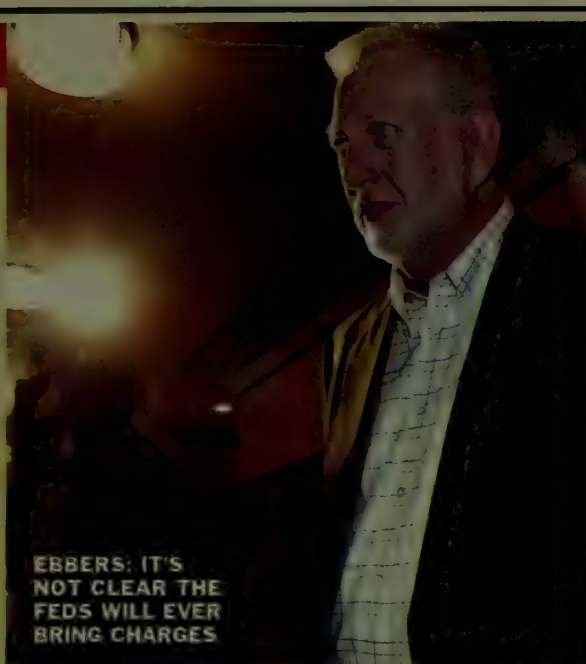
JEFFREY SKILLING
Enron



KENNETH L. LAY
Enron

That both main unindicted suspects are the most two powerful men in the Enron industry weighs heavily on Justice's Task Force.

d of former Adelphia Com-
s Corp. CEO John J. Rigas
and self-dealing is set for Jan-
lenies the charges. And ob-
believe Richard M. Scrushy,
of HealthSouth Corp., will
e indicted soon for his role in
scutors have called a scheme
he company's stock price.
ays he has done nothing
ren the Enron and World-
en are coming along, say Jus-
ts. "I understand that per-
as like we're not going after
s Associate Deputy Attor-
al William Mateja, Justice's
on the President's Corpo-
Task Force. "But we are."



EBBERS: IT'S
NOT CLEAR THE
FEDS WILL EVER
BRING CHARGES

Justice and the SEC argue that it
to piece together criminal casu-
ally white-collar ones. Many are
the bottom up, with lower-level
targeted first in order to gain
n against higher-ups in plea
s. Outsiders agree. "These rarely
that can be made with paper,"
ard Law School criminal law
Alan Dershowitz. "You need
to flip."
ly, prosecutors seem to have

more motivation—and means—to go af-
ter the big cheeses these days. Mateja
says cases that a decade ago took up to
four years to file now take six months.
As of May 31, Justice's corporate-fraud
task force—launched 14 months ago—
was handling more than 320 investiga-
tions, involving more than 500 people.
At the SEC, says a top law-enforcement
official, as many as 20 people have been
working the Enron case, while another
15 are on WorldCom full-time. Typically,

the SEC puts three people on a case.

Given the extra resources, some
outsiders wonder why more progress
hasn't been made. "When there is
that much firepower brought to an
investigation, neither complexity nor
time are viable excuses," says Jacob
S. Frenkel, a former federal prosecu-
tor and SEC enforcement lawyer who
is now a partner at Smith, Gambrell
& Russell. Frenkel specializes in
white-collar crime and is a vocal crit-
ic of the Enron investigation. But
even skeptics like him hold that
WorldCom, HealthSouth, and other
cases with more modest staffing are
moving at a good pace.

As for complaints that the SEC has
been slow to resolve charges against top
officials, the agency points out that that's
for good reason: With the two agencies
working so closely together, the SEC
doesn't want to muck up the criminal
probes by moving ahead with civil
charges that would reveal Justice's strat-
egy, witnesses, and documents.

Given all the hurdles, how likely is it
that the top brass will see their day in
court? Here's the current state of play in
the three largest alleged frauds.

to Skilling and Lay, Justice
assiduously working up the
t year, it won an obstruction of
dict against auditor Arthur
. It also has secured guilty
n two finance executives and
y traders. Indictments have
ined against former Chief Fi-
fficer Andrew S. Fastow; his
ner Assistant Treasurer Lea
Treasurer Ben F. Glisan Jr.;
l services CEOs Kenneth Rice
h H. Hirko; and at least seven
ner managers. All have plead-
ilty.

no documents directly linking
r Lay to any alleged crimes
rged. Many observers now be-
the only way for prosecutors
ilty verdicts against one or
would be to get help from one
f the small group of high-level
that routinely dealt with
nd Lay. That means Fastow,
rice, or Hirko would have to
u are going to need witness
y to bring the case against
or Lay] to life," says Philip H.
Houston white-collar criminal
ttorney who used to work for

While Skilling, by most accounts, was
deeply involved in the company's opera-
tions, "Lay only came back to Enron
[upon] Skilling's sudden retirement," says
Columbia's Coffee. "At the critical mo-
ment, he was [not hands-on]. It's not that
easy to hold him responsible for all the
special purpose entities."

All of Enron's indicted execs are sched-
uled to go to trial next year. Fastow and
Glisan face charges of wire fraud, securi-
ties fraud, and money laundering. Rice
and Hirko are charged with insider trad-
ing. Watch closely. The outcome will de-
termine whether the Enron Task Force
gets the energy giant's top players or
comes up empty-handed.



**RICHARD
SCRUSHY**
HealthSouth

Of all the investiga-
tions, HealthSouth's
seems the most ad-
vanced. Although

launched in March, it already has pro-
duced more indictments than the other

two. Fourteen former executives have
pleaded guilty to various crimes, ranging
from maintaining false books and records
to conspiracy to commit securities fraud.
Four former chief financial officers are
among those who have reached a plea
agreement with Alice H. Martin, the
U.S. Attorney for the Northern District
of Alabama.

All face possible prison time and big
fines, but the former CFOs who are pre-
sumably in the best position to implicate
Scrushy face the toughest penalties. Ac-
cording to Justice, William T. Owens, who
was still chief financial officer at the time
of his Mar. 26 indictment, is staring down
\$5 million-plus in fines and up to 30 years
in prison.

The rapid cooperation of such high-
level managers has outsiders feeling that
Scrushy, who maintains his innocence,
could face indictment soon. "With Richard
Scrushy, it's not a question of if he will be
charged, but when," predicts former pros-
ecutor Frenkel. To those who fear that
justice won't be done if the top dogs
don't face punishment, that would cer-
tainly be progress.

By Nanette Byrnes, with Mike France
and Susan Zegel in New York and
Paula Dwyer and Lorraine Woellert in
Washington, D.C.

(FROM TOP RIGHT) PHOTOGRAPH BY JEFF MITCHELL/REUTERS; LIVE PHOTOS. PHOTOGRAPH BY GARY TRAMONTINA/LOOMBERG NEWS;
PHOTOGRAPH BY JAY MALLIN/REUTERS; PHOTOGRAPH BY MARK WILSON/GETTY IMAGES. PHOTOGRAPH BY JEFF MITCHELL/REUTERS

COMMENTARY

By Diane Brady

WHY GE WENT FOR A LITTLE GLITZ

Jeffrey R. Immelt liked the movie *Seabiscuit*, and he even enjoyed himself once at a Universal Studios Theme Park in Orlando. But that's not why he wanted to merge Vivendi Universal's entertainment assets with NBC in a proposed equity deal valued at \$14 billion. The chairman and CEO of General Electric Co. insists that critics who say he was just snapping up a bargain from an anxious seller are wrong as well. "We're not in the business of flipping assets," says Immelt. "If I didn't think this improved our business strategically for the long-term good of our shareholders, I wouldn't do it."

The NBC-Universal deal fits neatly into Immelt's grand plan to transform his industrial and finance giant into a leader of the Information Age. For Immelt, content and distribution are the name of the game—whether it's critical health-care data for GE Medical Systems or a cable asset like USA Network.

And what of those who thought GE has long wanted out of the volatile media game? Immelt says they've got it wrong, too. He has long said that he wants to increase the heft and value of NBC, which had the company's biggest profit jump last quarter—a 26% gain, to \$688 million. But a bigger NBC inevitably meant moving beyond being just a broadcast network. The Vivendi assets give him a chance to do just that. "This is about stuff we know how to do," says Immelt, who also presided over the acquisitions of Spanish-language broadcaster Tele-mundo Communications Group Inc. and the Bravo cable channel since coming to the top job two years ago. "We understand the nuances of the industry and where it's going."

Moreover, the deal meets key characteristics that Immelt wants to see in all GE businesses: ties to technology, proprietary content, multiple revenue streams, control over how GE goes to market, and capital efficiency. "You don't have to build a film factory every year," he notes.

Sure, it's risky pairing the profit-

obsessed disciplinarians from GE with the artistic Hollywood types churning out shows and movies for Universal—a risk Immelt's predecessor Jack Welch was never willing to take. But Immelt needs to branch out if he is going to reshape GE into more of an information- and service-based company.



MOVIE STUDIO Volatile business, but boasts backlist of more than 5,000 film titles and room to cut costs

CABLE CHANNELS USA Network and others are strong revenue earners and will provide venues for distribution

TV PRODUCTION Hard to predict hits, though NBC will own a combined 32,000 TV episodes

THEME PARKS Least appealing asset for GE, which may soon sell its stake to an outside bidder

What about the entertainment industry's infamous hit-or-miss nature? Immelt and NBC Chairman Bob Wright are betting the volatility of moviemaking and theme parks will be smoothed over by steady revenues from other businesses, including cable networks and Universal's library of 5,000 film titles and a combined cache of 32,000 TV episodes. That could prove a gold mine in the new era of video-on-demand. Says Immelt: "It has become even more important now because there are so many different ways people view programming today."

Still, Immelt understands the perils. He acknowledges that running theme parks, for one, is

"something that we don't bring any management expertise to." And as movies and TV enter into the digital era, many worry that they will face the problem of illegal downloads. GE's famed management expertise, moreover, is no insurance against a box-office dud or disastrous tourist season.

But for now, investors like the new script. GE shares, which have dropped almost 50% from the giddy heights reached under Welch's regime, were up more than 5% in the two days after the deal was announced. One reason: The deal won't dent cash flow or earnings. Analyst Kerry Stirton of Sanford C. Bernstein notes that media companies often trade at a multiple of up to 27 times forward earnings, vs. the 18 multiple that GE commands. While the \$13 billion in combined revenues of NBC Universal last year is still less than 10% of GE's total, it adds a more lucrative element to the mix.

So will GE do a better job than others at reigning in the profligate ways of the entertainment industry? GE—which pays heavily for the mega-hit *Friends*—knows as well as any how hard it can be to try hammering down that \$20 million salary for the star of a big production when a competing studio is ready to offer even more. Still, if any corporation has a chance of making Hollywood more efficient, it's likely to be the buttoned-down folks at GE.

Associate Editor Brady covers GE.

BusinessWeek online

For a Q&A with Immelt, go to www.businessweek.com/magazine/extra.htm

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EMPLOYMENT BENEFITS

NEXT IN CALIFORNIA: ROLLING FREAKOUTS?

A bill for universal health care could whomp small business

All it takes to scare the daylight out of a small-business owner in California are three words: universal health care. That phrase has risen to the top of the agenda in Sacramento, where legislators are racing to get a health-care bill to Governor Gray Davis' desk before the recall election on Oct. 7. The bill would require most companies to provide health insurance for full-time and some part-time employees in California. And because it is supported by the powerful labor lobby, which is fighting hard to keep Davis in office, the governor just might sign it.

If he does, it could be the last straw for employers struggling to stay afloat in the Golden State. Many are buckling under high costs for energy and workers' compensation insurance—twice the national average. The health-care bill could double and even triple the cost of providing benefits for some companies. "It would be catastrophic," says Jack Kyser, chief economist for the Los Angeles County Economic Development Corp. The legislation is the most sweeping health-care proposal to get this far in the nation's most populous state. As such, its passage could also heat up the national debate over health coverage, just as the Presidential campaign season kicks off.

Business groups, including the California Chamber of Commerce, are trying to block the bill. As now written, it forces any company with more than 20 employees in California to provide health plans for all of its workers, or to pay a

fee to a state-run health plan. Companies with 200 workers would have to cover dependents as well. What's more, employers would have to shoulder at least 80% of each employee's insurance premium. For example, a company that now provides family coverage but pays only



IN SACRAMENTO

Supporters are pushing to get the bill passed and signed before Davis' possible recall

70% of the premium would see its health care costs jump an average of 15%, to \$6,000 per employee per year. Employers who now cover only workers could see expenses balloon as much as 150% once dependents are covered, too.

No one would be harder hit than the state's 1.1 million small companies, which employ 79% of working-age residents. Mitchell Greif, chairman of Coast Converters Inc., a Los Angeles plastic-bag maker, reckons the proposed law would add 10% a year to the \$300,000 he now pays for his 140 workers. He's not sticking around to see if the bill passes, though. He's moving his company to Las Vegas, where he'll save \$1 million a

year in health care, workers' comp, electricity, and other costs. "The writing's on the wall: We're not wanted here," Greif says. "So bye-bye, California."

The threat of more companies stampeding out of the state is likely to put a backseat to Davis' instincts of preservation. The bill is the pet project of Democratic state Senate leader J. Burton, who sees Davis' weakness as an opportunity to pass the bill by Sept. 12 when the legislature's current session ends. More important, the bill is co-sponsored by the California Labor Federation, which has launched a million-dollar campaign urging its 2.1 million members to vote against the recall.

With recent polls showing 50% or more of voters in favor of his recall, Davis may have little choice but to sign the bill to keep labor on his side.

As the debate rages on in Sacramento, local businessmen and national politicians will be watching closely. The bill's passage could provide a talking point for Democratic Presidential front-runners Dick Gephardt and Howard Dean, who have put universal health care high up on their campaign agendas. Back in California, businessmen such as KJ Hestehave will be bracing for difficult decisions. The owner of Bomatic Inc., a bottle maker in Ontario, Calif., plans to move his company to St. George, Utah, next year. Hestehave was considering leaving one manufacturing plant in California, but if the health-care bill passes, he says he may have to shut it down. "I just can't afford to provide these benefits," he says. "I feel like the state is showing me the door." A mandated health care could be the final swift kick that pushes more employers like him out of the state for good.

By Arlene Weintraub in Los Angeles

HEALTH CARE FOR MOST

California's proposal has business steam- ing. Here's why:

- Companies with more than 20 employees would have to provide health coverage for most workers. Those with more than 200 workers would have to cover dependents, too.
- Employers would shoulder at least 80% of the premium.
- The state would provide no financial incentives to help companies defray the costs of health insurance. Small companies, which provide 79% of the state's jobs, could be hit hard.

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STOCK MARKET

DIVIDENDS JUST AREN'T DAZZLING ENOUGH

In the rally, investors prefer to chase profits from stock gains

Eight months ago, President George W. Bush got lots of people excited about dividends when he suddenly proposed not taxing them so much. Companies were excited because this might be just the kick in the pants the stock market—and their own share price—needed. Investors were eager to collect a greater share of their companies' profits. And good-governance types, after a year of accounting scandals, were heartened at the prospect of companies raising their dividends to prove that their earnings weren't an illusion.

Now, looking back, was it all a big yawn? Sure, Microsoft Corp. paid its first-ever cash dividend in March. And Citigroup and Wells Fargo & Co. raised their dividends in July by 75% and 50%, respectively. But while Microsoft looked like a leader when it announced in January that it would start paying dividends, fellow tech titans Dell, Cisco Systems, and Oracle have not followed. Overall, companies are boosting their dividends, but not as fast as their earnings are growing. And investors, rather than skipping companies that don't pay dividends, are bidding up their stocks by twice as much as the shares of companies that do pay. No wonder, then, that when Merrill Lynch & Co. analyst John Davi studied this year's dividend payments, he found them "not anything extraordinary when you look at historical trends."

The numbers bear him out. Through August, 365 companies in the Standard & Poor's 500-stock index were paying dividends—up from 351 at the end of 2002, but still fewer than the 372 in 2000 and the 438 in 1990. Citigroup's 75% increase made big news, but just one-fifth of companies in the S&P 500 have raised their dividends even 10% this year. At the same time, S&P expects earnings from the continuing operations of companies in the index to climb 17% this year. And next year, S&P 500 companies will be paying out only

about 30% of their earnings, compared with an average 42% since 1988, S&P estimates. "I don't think there is going to be a structural change in dividend policy," Davi says.

What happened? For one, the levy on dividends wasn't cut as much as Bush proposed. Instead, Congress decided it would charge the 15% capital-gains rate, rather than personal-income rates that now range up to 35%. Congress also didn't make the tax cut permanent; it expires at the end of 2008. Doubtless that has added to investors' ambivalence. Stocks of S&P 500 companies that do not pay dividends have been up 44% this year through August, compared with 18% for dividend payers. So if the

tax cut gave any lift to dividend-paying stocks, it has been overwhelmed by market's rush back to growth stocks, particularly tech stocks, that don't pay dividends. Confronted with the choice of a cash dividend up-front or a chance at bigger gains later, investors are siding they will do better with companies trying to boost their shares by reinvesting their profits.

Last year was different, though. In a bear market, dividend-paying stocks held their value much better, losing 11% vs. the 30% drop for stocks without dividends. But now, with stocks going up, investors seem more inclined to let companies hold their profits for them.

At the same time, corporate executives have their own reasons to avoid paying dividends. They can use the money to fund acquisitions, invest in new factories and new markets, buy back stock, all of which can help consolidate their power and boost the company's share prices—and the value of their own stock options. What's more, dividends actually hurt the value of stock options (which offer no dividends) because stock prices dip after the payments are made to reflect the money paid out.

The tax cut, such as it is, is certainly still worth doing, experts say. While it has had a big impact on stock prices, it has focused attention on the bias in the tax code against dividends, which occurs because the money is taxed twice—as corporate profits and then as dividends. It has also encouraged debate about what companies do with shareholders' money, and made clearer the difference between a mature dividend-paying company and a growth company.

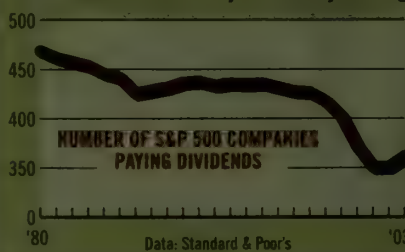
And, of course, the much-lamented revival of dividends could still happen. "It takes a long time to change a mindset, particularly when you have a lot of managements that are not used to giving shareholders control of profits," says Joseph Lisanti, editor of *The Corporate Look*, a publication of S&P, which, like *BusinessWeek*, is owned by The McGraw-Hill Companies. But as long as investors, often a gambling bunch, are happier chasing faster stock price appreciation than collecting reliable quarterly checks, dividends won't be much get excited about.

By David Henry in New York



WHERE'S THE PAYOFF?

Despite the dividend-tax cut, the number of dividend-paying companies remains far below the levels of just a few years ago



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EDITED BY MONICA ROMAN

FIRING UP THE REBATE ENGINE

THE 2004 MODEL YEAR DOESN'T officially start until Oct. 1, but the incentive battle for '04 models is already heating up. Chrysler Group on Aug. 28 raised incentives on most of its '04s to \$500 to \$3,000. The carmaker, whose sales are down 4.7% this year, says it's taking the lead in setting incentives from rival General Motors. GM on Sept. 3 kicked in an extra \$500 cash on some big trucks. Ford Motor now offers only minor 2004 incentives but may want to reconsider after August's 15% sales decline. Meanwhile, deals to move out 2003 models are in high gear.

AIRLINES: CLEARED FOR TAKEOFF

THE NATION'S BATTERED AIRLINES are finally showing signs of recovery, and relieved investors are boosting the

stocks. Thanks to decent summer traffic and reduced capacity, the major carriers reported packed planes and stronger revenue in August. Continental Airlines, for one, announced on Sept. 2 that its revenue for each seat flown a mile—a widely watched industry measure—rose a higher-than-expected 4% to 5% in August on a 1.7% increase in traffic. That's on top of a 4.8% unit revenue gain in July. Analyst Sam Buttrick of UBS Warburg now expects the major U.S. carriers to lose \$400 million in the third quarter, half the loss he previously forecast. Despite great uncertainty over how strong business traffic will be this fall, investors pushed up the American Stock Exchange airline index to near a 14-month high.

IS THERE A SCANDAL IN THE HOUSE?

WEBMD GOT AN UNWELCOME house call on Sept. 3, when federal agents searched its offices in connection with an ongoing probe. According to the Internet health-care company, the U.S. Justice Dept. is investigating its acquisitions of dealers who distributed its Medical Manager practice-management software for doctors. A 1999 financial restatement by Medical Manager is also under investigation. The company contends the search was based on information from two former employees whom WebMD has sued for taking kickbacks. WebMD says it does not expect the investigation to affect operations.

AN IRAQI VICTORY FOR MORGAN

J.P. MORGAN CHASE BEAT OUT competition that included Wachovia, Bank One, and Bank of America when it was named head of the newly cre-

HEADLINER: THEODORE WAITT

GATEWAY TO A COMEBACK?

Gateway CEO Theodore Waitt is still fighting to get his struggling PC maker back in the game. On Sept. 3, the Poway (Calif.) company said it would close one of its two manufacturing plants, cut 450 of its 8,500 employees, and outsource much of its production to partners it will select by the end of October.

It's the second major restructuring Waitt has undertaken this year. In March, Gateway closed 80 stores and laid off 1,900 employees. All told, Waitt expects to save \$515 million a year. Investors approve: Gateway's stock has

tripled to \$6 since March.

The cost-cutting will help win some breathing room for Waitt, who has struggled to fend off rival Dell for three years. Analysts expect Gateway to report a \$287 million loss on \$3.5 billion in sales this year.

The cuts will also buy time for Gateway's efforts to expand beyond PCs into such gadgets as digital TVs and digital cameras to pay off. Sales in its Gateway Country stores have been encouraging so far. But getting leaner will be the only way for the PC maker to curb its losses.

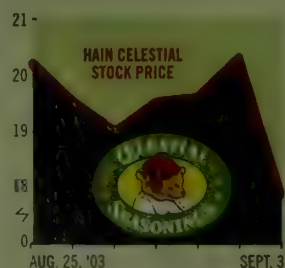
Arlene Weintraub



CLOSING BELL

BREWTAL

The news was less than heavenly when Hain Celestial Group, maker of Celestial Seasonings teas and Terra Chips, predicted earnings per share for fiscal 2004 will hit just 95¢ to \$1.03. With analysts expecting \$1.05, investors pummeled the stock: It fell 13% on Sept. 3, to \$17.65.



▲ DOLLARS
Data: Bloomberg Financial Markets

ated Trade Bank of Iraq on Sept. 2. J.P. Morgan will run a consortium of 13 banks representing 14 countries that will finance the rebuilding of the war-torn country. Almost 60 banks competed for the lucrative four-year contract, expected to bring in millions in fees. The new bank will guarantee purchases made by both the private and public sectors, much as trade banks did in Japan and Germany after World War II.

NEEDY NATIONS' NEW DRUG DEAL

THE POOREST NATIONS OF Latin America, Africa, and Asia will be able to import generic copies of drugs to fight the worst epidemics under a tentative deal worked out on Aug. 30 among the 146 nations of the World Trade Organization. Delicate negotiations in Geneva set the stage for much broader

WTO talks in Cancún, Mexico, on Sept. 10-14. The deal is a major victory for poor nations that are struggling with AIDS, malaria, and tuberculosis but lack the capacity to manufacture generic forms of patented medications. They will be allowed to import the drugs from nations such as Brazil, India, and South Africa without running afoul of international trade laws on patents. The deal requires manufacturers to follow certain guidelines to make sure the cheaper drugs don't wind up in other countries.

ET CETERA...

- Heinz' first-quarter earnings more than doubled from the year-ago period.
- A federal court stayed FCC's new media-ownership rules.
- The U.S. Energy Dept. is investigating the spike in gasoline prices.

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EDITED BY MIKE McNAMEE

MEDICARE REFORM: NO MIRACLE DRUG FOR THE GOP

When President George W. Bush kicked off a debate on Medicare reform last January, GOP strategists were exultant. By promising a new prescription drug benefit for seniors, Bush could neutralize an issue that Democrats have used to flog Republicans since the '60s. But as Congress heads into the homestretch on a Medicare overhaul, the opportunity looks increasingly like a trap. Bush will lose points if the Medicare reform effort fails. Yet voters may be disappointed by the bill that's likely to wind up on his desk.

The problem: The promised \$400 billion drug plan will fall far below the public's expectations. "People have in mind the benefit they had when they worked," says Robert J. Blendon, a Harvard University expert in health care and public opinion. "But \$400 billion does not get that level of benefits. Seniors are going to be very unhappy." A typical employer plan covers 70% of a worker's drug costs. But the Hill versions of a Medicare fix would pick up less than a third of a typical senior's expenses. So it's no wonder that support for Bush's handling of Medicare is slipping. An Aug. 24-26 Gallup Poll showed that 40% of those questioned approved of how he is managing the issue, down from 44% in late January.

The resistance may be strongest among those nearing retirement. Gallup reported that 81% of 50-to-64-year-olds think the new law won't do enough to help seniors pay for medications. And they fear losing employer-paid insurance when they retire. Today, just 23% of large companies offer retiree health benefits, down from 40% a decade ago. Administration analysts figure that coverage could drop by an additional one-third if businesses shift more responsibility for retirees to an enhanced Medicare.

The House and Senate must still work out key differences in their bills. The biggest: How much should Medicare be shifted to private insurers? Some union-connected groups

are blasting the House version as an attempt to gut the program. AARP, the powerful seniors' lobby, has expressed growing reservations about the House bill as well, though it still wants a drug benefit passed this year. But House conservatives won't back off from their bill's reforms.

Still, the basic drug insurance is similar in both bills. In each, most benefits won't kick in until 2006. Thus, voters won't know what the new law will mean to their personal drug costs when they go to the polls in '04. Many will expect the worst, and Dems will play to that uncertainty.

"The speculative fear that you're going to lose something you value today is a recipe for disaster for politicians," says Michael F. Smith, vice-president for government affairs at the Heritage Foundation.

The political minefields may be one reason Bush has kept a low profile in the Medicare debate. Since his own ambitious restructuring ideas were shot down in January, Bush refused to push for specific reforms. "He's keeping his distance," says a Senate GOP aide.

But GOP leaders figure they must move ahead despite the dicey politics. Aides to Senate Majority Leader Bill Frist (R-Tenn.) say that failing to pass a Medicare package will hurt the GOP far more than enacting an imperfect plan. Jonathan Oberlander, a professor of social medicine at the University of North Carolina,

agrees: "If I were in the White House, I would tell lawmakers, 'If we cannot pass this, you are going down.'

In a close election, Medicare could be critical in several heavy states such as Florida and Pennsylvania. That's why, in the end, Bush will likely pressure conservatives to swallow a bill they don't like and take their chances on Election Day. Medicare reform won't be the bonanza the GOP was hoping for. But it will still be better than doing nothing at all.

By Howard Gleckman



FRIST: *Let's pass a plan*

CAPITAL WRAPUP

CAMPAIGNING?

► Harvard University economist Martin Feldstein sounded a lot like an aspiring Federal Reserve chairman at the Fed's annual conference in Jackson Hole, Wyo. Feldstein, a leading candidate to take over the central bank when Alan Greenspan steps down in a few years, backed Greenspan's flexible policy approach and rejected using inflation targets to set interest rates. He also repeatedly praised President Bush's big tax cuts, saying they were particularly well-timed.

SLIP-SLIDING AWAY

► President Bush isn't the only one suffering in the polls: His top Cabinet aides are losing popularity, too. Attorney General John Ashcroft's positive rating has sagged to 48% amid liberal and conservative criticism of his civil liberties record, according to an Aug. 12-17 Harris Poll. Defense Secretary Donald H. Rumsfeld has slipped from 71% in April to 55%. At the bottom of the heap: the invisible man, Vice-President Dick Cheney, at 42% positive, 45% negative.

WHITE HOUSE, EH? JA!

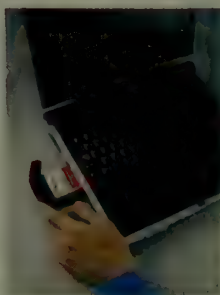
► Ideological opposites Representatives John Conyers Jr. (D-Mich.) and Darrell Issa (R-Calif.) are coming together on the idea of a constitutional amendment to allow foreign-born citizens to serve as President. The move would clearly benefit Arnold Schwarzenegger, the Austrian-born actor currently running for governor of Issa's home state. But Conyers may have another candidate in mind: Canadian-born Governor Jennifer Granholm of Michigan, a rising Democratic star.

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AIG'S ASIAN CONNECTION

Can it maintain its strong growth in the region?

American International Group Inc. has no shortage of clout in Asia. Founded in Shanghai in 1919 and a constant presence in Tokyo since 1946, the \$67.5 billion life-and-property colossus is now the top foreign insurer both in China, the world's fastest-growing market, and Japan, the world's second-largest after the U.S. AIG, or one of its many subsidiaries, are household names throughout much of the region, from Korea to Thailand. For the past 35 years, Chairman Maurice R. "Hank" Greenberg has nurtured the business by hobnobbing with regional leaders, offering advice on everything from pension reform in Hong Kong to China's entry into the World Trade Organization.

The financial-services behemoth earned about a third of its record revenue last year from Asia and a significant—but undisclosed—chunk of its \$5.5 billion profit. Sales in Asia last year were double what AIG earned in the region just five years ago (table). But Greenberg isn't content to sit back and collect premiums. Instead, AIG is setting up shop in growth markets such as India and taking over rivals in more mature markets like Japan. The biggest prize by far, however, is China, where Greenberg boasts: "We're growing very strongly."

The catch? The world's most profitable insurer remains a bit player in Asia's most promising foreign markets. To grow, AIG must outwit rivals and win over regulators who often cast a wary eye at foreigners. In China, where AIG reopened its doors in 1992, it faces big local players. "The [Chinese] market is incredibly competitive, and foreign companies can't penetrate as much as expected," says Connie Wong, an analyst at Standard & Poor's in Hong Kong.

AIG, however, has a huge lead over other

foreign insurers. And while the outbreak of SARS had a short-term impact on insurance-contract sales in April and May, AIG expects severe acute respiratory syndrome to actually increase life-insurance sales, longer-term. AIG's Chinese operations have cranked out 28% sales growth during the first half and, Greenberg thinks, are on track for a 40% gain by yearend. It's currently the fifth-largest insurer in China in terms of premium income, with eight branches each for its life and nonlife insurance business. Last year, AIG became "the first foreign life insurer to do business in the populous and prosperous cities of Beijing, Suzhou, Dongguan, and Jiangmen," Senior Vice-Chairman and co-CEO Edmund Tse boasted to shareholders in May.

Still, AIG must win business away from local giants such as state-controlled China Life Insurance Co., which underwrites more than half of all policies in the country. China Life is expected to raise \$3 billion in an initial public offering this year and likely will be the dominant life insurer for years to come. No.2 Ping An Insurance Co. is about half the size of China Life but dwarfs AIG's China branch, which operates under the name American International Assurance (AIA). Whether AIG can be more than a niche player is an open question.

Skepticism doesn't bother Greenberg. The feisty exec insists AIG can out-hustle local ri-

vals with an innovative array of financial products such as SARS-related insurance, stricter cost controls on overhead, and top-notch ratings from credit agencies—a major selling point in a region fraught with wobbly insurers. "I've opened [China's] market for insurance," says the 78-year-old.

Other foreign insurers operating in China can't quibble with that. But they whisper that AIG has a sweetheart deal as the only foreign insurer allowed to operate wholly owned subsidiaries. Others must settle for minority joint ventures. But Greenberg calls it just desserts, noting AIG worked 17 years to get an insurance license. "Who in the European insurance industry went to China?" he says. "If they did, they would be a tourist."

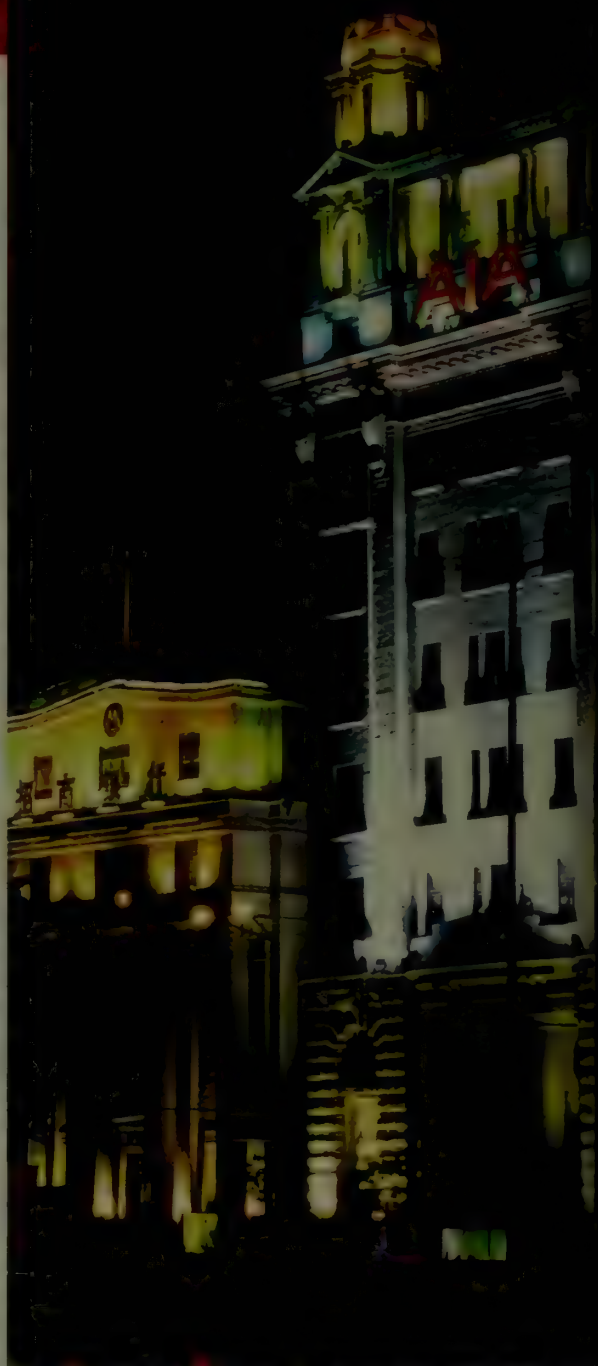
While China is a long-term play, AIG's short-term prospects look better

Gangbusters in Asia

AIG's annual revenue in billions of dollars

YEAR	U.S.	ASIA	NON-ASIA FOREIGN	TOTAL
2002	\$39.8	\$19.2	\$8.5	\$67.5
2001	36.2	17.1	8.5	61.8
2000	33.5	15.3	7.5	56.3
1999	30.6	13.2	6.9	50.7
1998	28.3	10.6	6.7	45.6

Data: AIG



Japan. There, the chief concern is a sluggish Japanese economy. To keep up the pace of growth, Greenberg is turning to acquisitions. AIG took over ailing Japanese insurer Chiyoda Mutual Life Insurance Co. in 2001. Last year, it bought a 22% stake in Fuji Fire & Marine Insurance Co. Then in June, AIG shelled out \$2.1 billion for General Electric Co.'s Japanese life-insurance business, known as GE Edison Life Insurance Co., and the company's U.S. auto and home-insurance businesses. GE wanted out, and AIG was happy to help. "They didn't have a big insurance operation in Japan. They didn't have critical mass," Greenberg says.

AIG faces an uphill battle in India, where it's a latecomer, and rivals such as Prudential and Germany's Allianz have big leads. Since partnering with Tata Group two years ago, AIG and Tata have pumped \$75 million worth of capital into a jointly owned insurance company. While premium growth has been impressive, the venture is up against state-owned giants Life Insurance Corp. and General Insurance Corp., a property-and-casualty outfit. AIG's 12,000 agents are competing against 80,000 at LIC. But Kavarana, who heads Tata-AIG, says the company is there for the long haul: "We hope to be profitable in 4 to 8 years for general-insurance products and 8 to 10 years in life."

Greenberg says he wants to be the best foreign insurer in India in 10 years, underscoring his reputation as a driving boss. That drive explains why AIG last year was the most profitable multiline insurance company in the world. Asia has been very good to AIG. And Hank Greenberg aims to make it stay that way.

by Brian Bremner in Tokyo, with
Ajay Kripalani in Bombay

COMMENTARY

By Moon Ihlwan

WASHINGTON AND SEOUL: DRIFTING FURTHER APART?

It was a mind-wrenching scene on the last frontier of the Cold War. As six nations squared off for a diplomatic sparring match over North Korean nuclear arms in Beijing at the end of August, a competition of a different sort was under way in Daegu, South Korea. There, 11,000 students gathered for the World University Games, including

against attack. The U.S., however, refuses to even talk about concessions until Pyongyang abandons its bomb program. South Korean officials think Washington should be more flexible.

However naive it may seem, many South Koreans have lost their fear of the Stalinist regime in Pyongyang and embraced Dear Leader Kim as a partner in reunification. To these



South Korea's ties with Beijing and Pyongyang are reshaping the alliance

**"WE ARE ONE" AT
THE DAEGU GAMES**

competitors from South and North Korea. But there was no rancor. When a North Korean cheering squad started up a chant of "We are one," students from both ends of the divided peninsula joined in lustily. And during a North Korea-U.S. volleyball match, fans booed the Americans and cheered North Korea.

Maybe U.S. negotiators should attend games like these. They show how differently North Korea is viewed in South Korea these days. American policymakers, of course, already know that many young South Koreans feel resentful of the U.S. and protective of their North Korean cousins. Such sentiments helped elect activist Roh Moo Hyun President last December. Still, the U.S. thought it had won a victory when it finally forced Kim Jong Il to accept the six-party talks, which included the two Koreas, Japan, Russia, China, and the U.S.

Instead, the talks, which ended on Aug. 29, just reinforced anti-American sentiment, with critics in Seoul denouncing the U.S. for its stubbornness. The North said it would give up its nuclear ambitions if the U.S. would at the same time guarantee it

doves, it's the hard-liners in the Bush Administration who are blocking a diplomatic solution to the nuclear crisis. Roh, while trying to work with Washington, also insists on maintaining economic cooperation with the North despite the nuclear issue, whatever the U.S. thinks.

There's another twist: Seoul's new appreciation of China, its big trading partner. The South Korean media played up a Sept. 1 comment made by China's chief delegate to the talks, Vice-Foreign Minister Wang Yi, when he declared that U.S. intransigence is "the main problem we are facing." For South Korean youths with no memory of the Korean War, China is seen as a cultural partner and promoter of regional peace, while the U.S. is the bully.

Seoul's growing ties with Beijing and Pyongyang present Washington with a dilemma. Caving in to the North's demands seems unthinkable. Ignoring the wishes of its ally in the South also seems impossible. Either way, the U.S.-Korean alliance is changing profoundly.

Moon covers Korean business and politics from Seoul.

BusinessWeek online

For a Q&A with AIG's Hank Greenberg, go to <http://www.businessweek.com/magazine/extra.htm>

CHINA

IT'S TIME FOR A NEW PLAYBOOK

Sponsors find sports marketing in China is no slam dunk

When PepsiCo Inc. marketing executives signed a five-year deal to sponsor the China Football Assn. in 1999, they thought they had a sure bet. The agreement included a commitment by state-owned China Central Television to carry at least 30 soccer matches per season, putting Pepsi's brand in front of hundreds of millions of viewers each week. But CCTV showed fewer games than Pepsi expected, and by 2002 had stopped airing matches altogether. Though broadcasts resumed later in the season, Pepsi pulled the plug on the deal. "Sports marketing in China is very challenging because things are still so muddled," says Pepsi vice-president Richard Lee.

Just a few years ago, China appeared to be the next frontier for sports marketers. Shanghai hosts an annual pro tennis tournament and plans to open a Formula 1 track next year. The 2008 Olympics are to be held in Beijing, and basketball is so established that some Chinese players—particularly Yao Ming—have become global stars.

But companies that rushed to plaster their brands on mainland teams and leagues are rethinking their strategies. Motorola Inc. has decided to stop sponsoring the Chinese Basketball Assn. Fuji Photo Film Co. and Virgin Atlantic Airways declined to renew soccer deals. And Philips Electronics has dropped its backing of the national men's soccer team, though it continues to work with a university soccer league. International companies often "cannot justify the returns on their investment," says Scott Kronick, managing director of Ogilvy Public Relations Worldwide in Beijing.

That's not to say everyone is throwing in the towel. The first division soccer league is now called the Siemens Football League, thanks to a cash infusion from the German electronics maker. Adidas-Salomon recently signed a deal to back China's national soccer teams through 2010. And the corporate world is lining up to get a piece of the



WHILE FOREIGNERS SPONSOR CHINESE SPORTS...

SPONSOR	TEAM/LEAGUE SPONSORED
ADIDAS	National soccer team
SIEMENS	First division soccer league
COCA-COLA	National basketball team
PHILIPS	National women's soccer team, university soccer league

...CHINESE COMPANIES ARE BACKING TEAMS ABROAD

KEJIAN	Everton (English Premier League)
YANJING BEER	Houston Rockets (NBA)

Data: BusinessWeek

Olympics, which will have official sponsors of everything from mobile phones to insurance.

Yet efforts to market products through the Chinese sports establishment haven't exactly been a slam dunk. The problem? For starters, there's a serious lack of marketing savvy among sports officials and team owners. "People in charge of sports need to begin embracing the consumer," says Terry Rhoads, general manager of Zou Marketing, a sports-marketing consultancy

in Shanghai. And Chinese fans among the most fickle on earth. When their teams lose, they stay home; they don't make a lasting connection with the players—or the sponsor. Worse, it's hard to gauge the value of sponsorship. Market research is still in its infancy in China, and good data on TV viewers are hard to come by.

At the same time, foreign soccer and basketball are surging in popularity, which makes it even more difficult for local teams to grab the limelight. "International games are very exciting, but local teams really stink," says Sun Pei Yuan, a 27-year-old economics researcher from Shanghai. Most Chinese soccer fans would be hard-pressed to name a local star. "In the U.S., let alone the NBA, you have superstars like Yao Ming," he says. "In China, there's often not even food."

Given the limited opportunities with Chinese teams, companies such as Siemens, Nike, and Philips have parlayed global sponsorships into greater awareness in China. Siemens signed with the Houston Rockets last year, interest in the NBA has soared in the mainland, now the league's largest TV market outside the U.S. Some Chinese companies are even spending on sports-marketing dollars overseas. Mobile-phone maker China Kejian Co. has paid \$1 million to sponsor English Premier League team Everton—where Chinese midfielder Li Tie plays for three years. And Harbin Beer, the U.S. distributor of China's Yanjing Beer, has a \$6 million sponsorship deal with Yao's Rockets.

Some multinationals, meanwhile, are focusing instead on grassroots programs. Pepsi is sponsoring teen soccer, Adidas is funding camps dedicated to the sport, and Nike has started a high school basketball league. "It's a big challenge—to give you more and more access to organized sport," says Paul Pai, Adidas general manager in Shanghai. But who knows? The company that helps nurture the next Yao Ming just might be on the player's short list when it comes to future sponsorship deals.

By Frederik Balfour in Hong Kong

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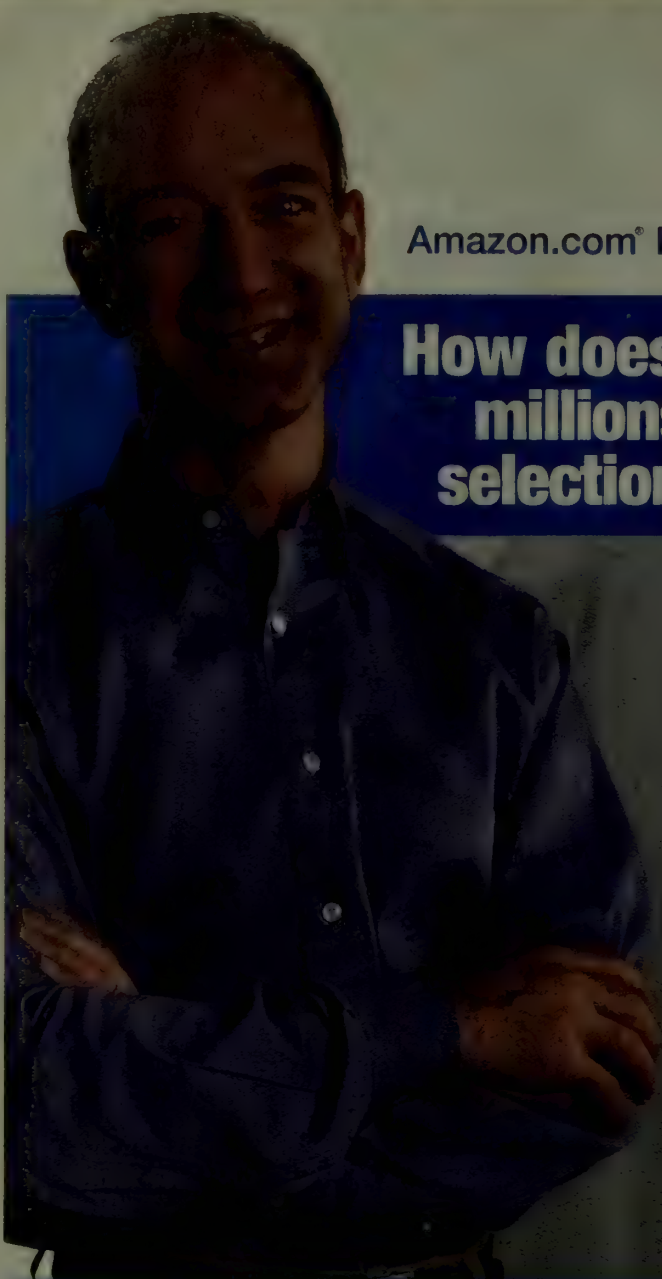
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EDITED BY ROSE BRADY

WILL WASHINGTON KEEP THE SCREWS ON LIBYA?

The U.N. Security Council is on the verge of lifting sanctions imposed on Libya for allegedly planning the 1988 bombing of Pan Am Flight 103 over Lockerbie, Scotland. A U.N. vote, expected any day, comes after Libyan leader Muammar Qaddafi finally, on Aug. 15, bowed to U.N. demands to accept responsibility for the bombing. He also agreed to pay \$2.7 billion to compensate victims' families. But Qaddafi hasn't shaken his pariah status yet. A wide range of U.S. restrictions on investment and trade with Libya remains in place, and the Bush Administration is fiercely divided over whether to lift them. At issue is more than just the testy relations between longtime foes, or even the profits of companies such as Amerasia, ConocoPhillips, and a handful of others that stand to regain access to rich Libyan oil and gas concessions, some of which date back to the 1950s.

Instead, at stake is a potentially important question in the war on terrorism: If a state that sponsors terror changes its ways, should it be dropped? The answer to this question could determine whether other countries on the administration's list of terror-sponsoring nations—Iran, Sudan, Cuba, North Korea, and others—see any reason to change their behavior. And, of course, the fear of becoming the target of "regime change." Lifting sanctions on Libya "creates an incentive for [countries] to do the right thing," says Jon B. Alterman, a former State Dept. official now at the Center for Strategic & International Studies in Washington.

Liberal camps are facing off in this debate. Conservative lawmakers want to keep U.S. sanctions on Libya to pressure Qaddafi to improve his human-rights record and punish him for allegedly developing weapons of mass destruction. An administration source says National Security Adviser

Condoleezza Rice has ordered a policy review, including an analysis of intelligence suggesting Qaddafi is developing chemical weapons and retains contacts with some terrorist groups.

The various diplomats, think tanks, and lobby groups that favor a lifting of sanctions argue that Libya's steps to meet international demands should be cautiously recognized. Instead of undermining its neighbors, Tripoli is now mediating African conflicts. While the regime may still have ties to some terrorists, it isn't the financial and ideological sugar daddy it once

was. A target of al Qaeda, which tried to destabilize Libya in the 1990s, Qaddafi's government is even sharing intelligence with Washington. If the U.S. doesn't reduce sanctions, the message it would send rogue nations is that "it doesn't matter what you do, you're a marked regime," says Chester A. Crocker, a former diplomat who led a review of Libya policy for Washington's Atlantic Council think tank.

Rice's review of Libya will likely take weeks. Only then will President George W. Bush decide whether to rescind executive orders dating back to the 1980s, pre-Lockerbie, when Qaddafi was stirring up trouble on numerous fronts. These orders froze about \$1 billion in Libyan assets and prohibit all investment and almost all trade with Tripoli. The 1996 Iran-Libya Sanctions Act, which bars any oil-industry investment of more than \$20 million in Libya,

lifts sanctions once the President certifies that the country has met U.N. demands.

The White House's decision is made all the more difficult now that the Pan Am 103 families have a deal. "Every Administration has been able to hide behind the families," says Stephanie Bernstein of Bethesda, Md., whose husband died in the crash. "Now they can't do that anymore." For the Bush team, the war on terrorism gets more complicated by the day.

By Stan Crock in Washington



QADDAFI: A U.N. deal

GLOBAL WRAPUP

KOIZUMI'S LEADERSHIP RACE

With a public support rating of nearly 60%, Junichiro Koizumi ranks as one of Japan's most popular Prime Ministers in years. But that may not be enough to ensure that he hangs on to his post. Shizuka Kamei, a popular right-wing member of the ruling Liberal Democratic Party, has emerged as a strong contender in the race for the post of LDP president. The victor, once decided in a party poll on Sept. 1, will not only take charge of the LDP but also assumes the premiership.

What gives? Koizumi has never been as popular with the LDP as he is with Japanese voters. He rose to power two years ago on a wave of support for his reform agenda. But many LDP politicians have since grown disillusioned with his reforms, blaming them for the country's drawn-out slump. "Koizumi is responsible for this recession," Kamei, the challenger, declared in a TV interview on Sept. 1.

So far, Koizumi has introduced structural economic reforms, overhauled the health-care system, and slashed public works spending. In the

process, he has alienated LDP interests such as the construction sector, which depends on public works projects for its lifeline. Unfortunately for Koizumi, a majority of the 1.4 million card-carrying LDP members are opposed to his brand of reforms. That might make them more receptive to Kamei, who promises to boost the national budget by up to 10% for three years with—guess what?—more construction-related public works. It's too early to call the election. Koizumi, however, will have to fight to keep his job.

By Irene M. Kunii in Tokyo

A woman with dark hair, wearing a white long-sleeved top, white trousers, and red shoes with white bows, stands behind a large blue sign. The sign has the words "STEALS DAILY" in white, bold, sans-serif capital letters. The sign is mounted on a white wall. The woman is looking towards the camera. The background is a plain white wall. The floor is covered with a grey and white checkered pattern.

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POLITICS

THE EVOLUTION OF CAMPAIGN FINANCE?

Liberal groups have joined forces to amass cash and clout

Imagine a political organization with more than \$250 million in the bank, a fine-tuned direct-mail operation, some of the best political minds in the country, and legions of volunteers at the ready. It might sound a lot like the Republican or Democratic machinery in a Presidential election year. But it isn't.

This group is America Votes, a confederacy of liberal causes that is mobi-

lizing to fill the money void left by a new campaign-finance law that is hampering Democrats' fund-raising. It's the first big organization to emerge from the confusion left by the 2002 Bipartisan Campaign Reform Act (a.k.a. McCain-Feingold), which cut the flow of big-dollar "soft money" donations to parties. With a Presidential election bearing down, America Votes pulls together

some 20 progressive interests in a kind of shadow party (table).

As the Supreme Court prepares to hear arguments Sept. 8 on BCRA's constitutionality, America Votes is the evolutionary response to the law's fundraising restrictions. And it might be the only way for Dems, who long have relied on now-banned donations from unions and wealthy givers, to stay in the game against the GOP's money vacuum, which sucks up thousands of small legal smaller contributions. President George W. Bush and the Republican National Committee are on target to raise a record half-billion dollars before Election Day 2004.

Critics warn that America Votes groups like it threaten to wrest control of electoral strategy from the parties, deliver the message to the fringes of the Left and Right, and make it more difficult for Presidential nominees to run as centrists. Ultimately, these groups could represent an end run around BCRA if they become too cozy with the party machinery. "If somehow 'coordination' with the party becomes a wink and a nod, it would render our efforts really meaningless," says Senator Russ Feingold (Wis.), who sponsored reform legislation with Senator John McCain (R-Ariz.).

So far, the emerging system is an improvement. With politicians once removed from fund-raising, they spend less time groveling for money. Once elected, they'll be insulated from donors seeking favors. Disclosure rules will keep money flows visible. "The system is working even if it forces money away from these soft-money groups, because it's breaking that connection" between donors and lawmakers, says Larry L. L. L., executive director of the Center for Responsive Politics.

America Votes has the potential to replace the Democratic Party as the center of liberal efforts. It will be governed by a top-flight list of Democratic insiders. President Cecile Richards, daughter of former Texas Governor Ann Richards, is a former deputy chief of staff to House Minority Leader Nancy Pelosi.

ANATOMY OF A SHADOW PARTY

America Votes is coordinating the spending and grassroots campaigns of some 20 liberal interest groups in an effort to defeat President Bush

HOW IT WORKS

The group will focus on get-out-the-vote efforts. Labor groups will take the lead in blue-collar areas, enviros might target wealthier suburbs. Tools will include direct mail, phone banks, canvassing, and TV and print ads.

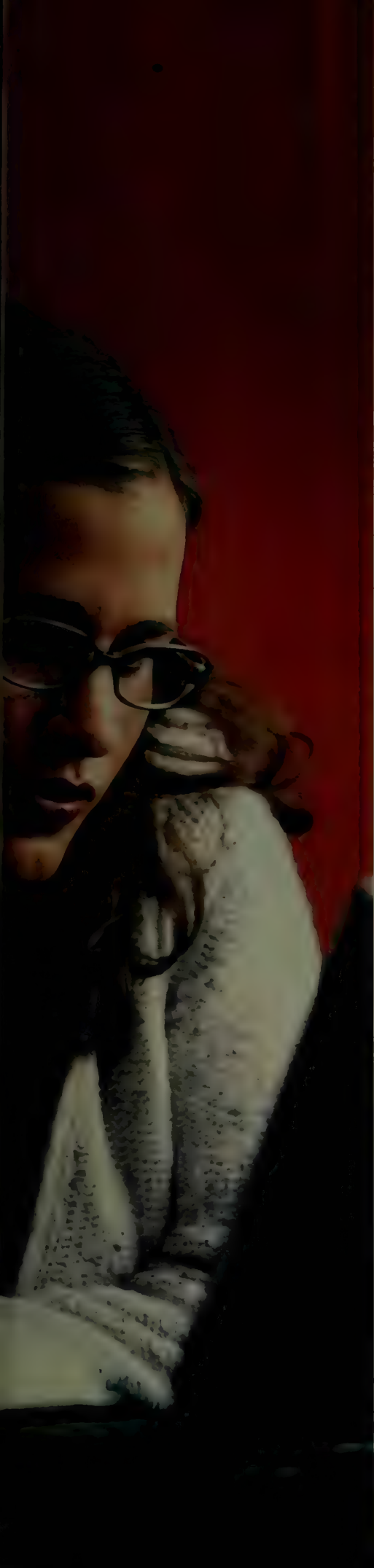
WHO'S ON BOARD

Members include: The AFL-CIO, the NAACP, the National Education Assn., the Association of Trial Lawyers of America, Planned Parenthood, the League of Conservation Voters, and liberal Web site Moveon.org.

WHO'S IN CHARGE

Cecile Richards, president, is a leading abortion-right activist. Carl Pope, treasurer, is executive director of the Sierra Club. Ellen R. Malcolm, secretary, runs EMILY's List, a top fund-raiser for Democratic women candidates.

Data: BusinessWeek



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(D-Calif.). Founders include AFL-CIO President John Sweeney, New Mexico Governor Bill Richardson, and Gregory T. Moore, executive director of the NAACP National Voter Fund.

The goal is to turn out the vote in swing states such as New Mexico, Florida, Iowa, Minnesota, New Hampshire, and West Virginia. Member groups will share polling data, research, and mailing lists, including "Demzilla," the Democratic National Committee's massive voter data bank. They'll ante up \$50,000 each to hire coordinators in as many as 17 states. "It doesn't make sense to be talking to the same voters and knocking on the same doors on the same evenings," Richards says.

America Votes will have help from a new political action committee, America Coming Together, which expects to raise \$75 million by Election Day in pledges from wealthy donors. Among them: billionaire financier and Bush critic George Soros, who is kicking in \$10 million because "the current set of reforms give an advantage to the Republicans." A \$50 million media campaign to support the Democratic nominee, led by Harold Ickes, President Clinton's former deputy chief of staff, will complement ACT's ground war. Ickes isn't worried about a ban on coordinating with the party: "It doesn't take much to figure out what the issues are and the messages you need to be helpful."

But some critics wonder how helpful these groups will be. If the nominee depends on America Votes, any attempt to move to the center to woo swing votes risks muddling the message or alienating America Votes funders. "This is one of the greatest dislocations of political power in the 200 years of the republic," says GOP lawyer Jan Baran, who represents BCRA challengers.

For voters—and major contributors—the bigger question is whether these surrogate parties eliminate the quid pro quo between pre-election donations and post-election favors. "Are they being told, 'Give your half-million to this group and don't worry—the candidate will know about it'?" asks Georgetown University law professor Roy A. Schotland.

Some analysts predict these intermediaries will make it harder for donors to call in chits—and that might chill contributions. "Will national donors be willing to give to these groups if they don't get credit for it?" says Kent Cooper, co-founder of PoliticalMoneyLine.com, which tracks campaign donations. "A lot of them are probably hesitant." If so, that means less cash for campaigns—and a win for reformers.

By Lorraine Woellert
in Washington

The Workplace

LABOR

BREAKING RANKS WITH THE AFL-CIO

Five union chiefs are making a joint push for new members

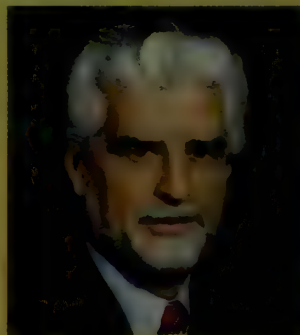
Earlier this year, a group of union leaders eager to reverse labor's long-term decline goaded AFL-CIO President John J. Sweeney into setting up a streamlined new governance structure for the federation. Their goal: a complete overhaul of the AFL-CIO to focus it like a laser on getting labor's ranks growing again. Sweeney broadly agrees with them, but he bris-

tled at the activists' moves and has essentially sidetracked the new executive committee instituted last February.

Now, *BusinessWeek* has learned, the rebellious labor chieftains have decided to take matters a step further by creating their own mini labor federation. Since early July, the head of the Service Employees International Union (SEIU) and four other labor presidents have r-

LABOR'S GANG OF FIVE

► A handful of organizing-focused union presidents, impatient with the AFL-CIO's slow progress on recruitment, are forming a new labor group—but not splitting from the federation



Doug McCarron

- International Brotherhood of Carpenters
- Industry: Construction
- 530,000 members



Terry O'Sullivan

- Laborers International Union
- Industry: Construction
- 320,000 members



Bruce Raynor

- UNITE
- Industry: Needle trades, laundry
- 200,000 members



Andy Stern

- Service Employees International Union
- Industries: Health care, maintenance
- 1.3 million members



John Wilhelm

- Hotel Employees & Restaurant Employees
- Industry: Hospitality
- 240,000 members

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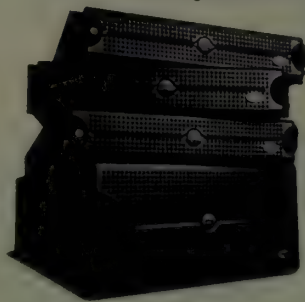
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times to map out what they're in-
ally calling the New Unity Partner-
On Sept. 2, they gathered again in
ington to discuss hiring staff and
lizing an agenda. The idea is to
ew ways to stimulate growth in
rolls—for example, by mounting
recruitment campaigns against large
al companies or across geographic
is. "The question is: Can we create
thing to help us all grow faster?"
SEIU President Andrew L. Stern,
union, the AFL-CIO's largest, is one
few that has been gaining mem-
n the private sector.

the five, who have been talking to
sters President James P. Hoffa
joining their ef-
also continue to
out their ideas
forming the AFL-
They have been
ssing the issues
had hoped to
in the federa-
new executive
ittee, such as re-
g or eliminating

AFL-CIO functions to free up re-
es for growth. At this point, they're
alking about quitting the AFL-CIO—
the course one of them, Carpen-
President Douglas J. McCarron, took
years ago after his frustration over
ederation's inaction boiled over. Nev-
less, "that could happen if things
change," says one of the other four.
e gang of five are part of a new
ation of labor leaders, mostly in
early 50s, who want to see more
nt action to stem labor's decline.
ive have put their own unions
gh often painful transformations,
ng bureaucracy and focusing dwin-
resources on recruitment. Now,
want to make bold moves across
ederation, such as throwing hun-
s of recruiters and other resources
major organizing campaigns. "We all
ve this is a critical time for labor,
we're not prepared to let it disap-
on our watch—not without an ef-
py us," says Bruce Raynor, presi-
of UNITE, the needle trades union.
problem is, most union leaders are
ed about just how militant they
to be. Many seem content to bar-
for existing contracts and make to-
efforts to refocus on growth. Only a
ful have restructured themselves
ig organizing pushes, despite years
hortation by Sweeney and others.
w chiefs have been taking steps to
e membership gains but perceive
ive as divisive or grandstanding.
AFL-CIO's doing a better job than it

has in years," says one top union leader.

Complicating matters is the percep-
tion that several of the five harbor am-
bitions to replace Sweeney when his
term expires in 2005. So their agenda
hasn't been greeted with open arms.
Indeed, the New Unity Partnership in
some ways reflects a failure of the five
to garner support for their program,
prompting them to strike out on their
own. AFL-CIO officials, for their part, vac-
illate between trying to accommodate
the conflicting views of union presidents
and lashing out at those challenging
Sweeney's priorities. "Anyone who says
you can crack a whip or knock heads
[to force unions to change] is crazy,"
says Denise Mitchell,
Sweeney's assistant
for public affairs.

**"We're not prepared
to let [organized
labor] disappear on
our watch"**

If the partnership
gets off the ground,
employers could see
some stronger organ-
izing drives. One ex-
ample: UNITE and the
Teamsters have al-
ready joined forces to

target 17,000 workers at Cintas Corp., a
leading commercial launderer. UNITE has
successfully unionized smaller rivals in
the industry and may be able to put
up a real fight with the clout of the
much larger Teamsters, which also rep-
resents laundry workers.

The group is also talking about tar-
geting industries by region. Florida and
Arizona are two states they're eyeing.
The SEIU has contracts with real estate
and management companies for building
workers, while the Laborers and Car-
penters deal with the construction com-
panies that build the properties. The
idea is to push unionized employers in
one industry to allow unimpeded organ-
izing in the others. They want to target
hotel chains, too, where the hotel em-
ployees union has members. "Far too
many hotels are built by members of
my union but run nonunion, or vice ver-
sa," says Laborers Union President Ter-
ence M. O'Sullivan.

Many of these ideas are already being
tried by some unions, including most of
the five. Still, this would be the first
organization dedicated to helping unions
grow again. If it works, other unions
are likely to sign on—and one of the
five would likely take over the AFL-CIO
and try them on an even broader scale.

By Aaron Bernstein in Washington

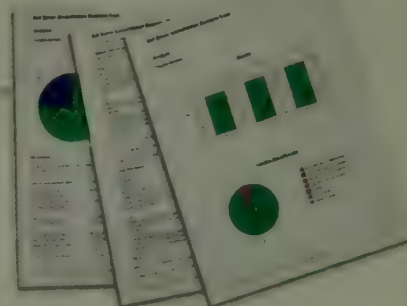
BusinessWeek online

For a Q&A with SEIU President Andy Stern, go
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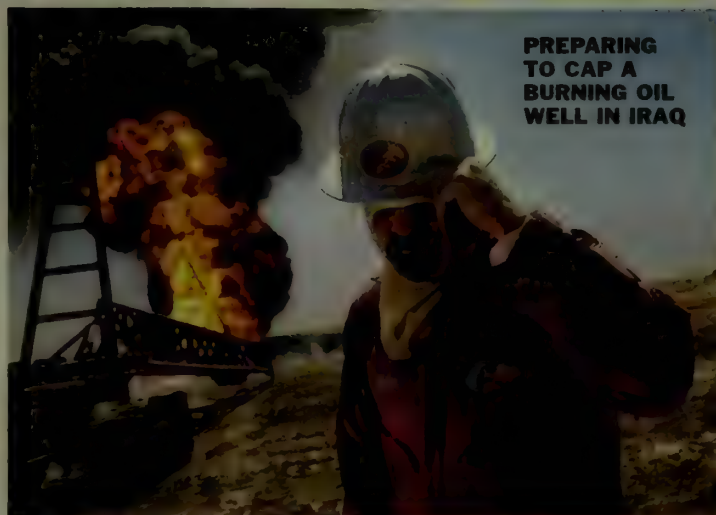
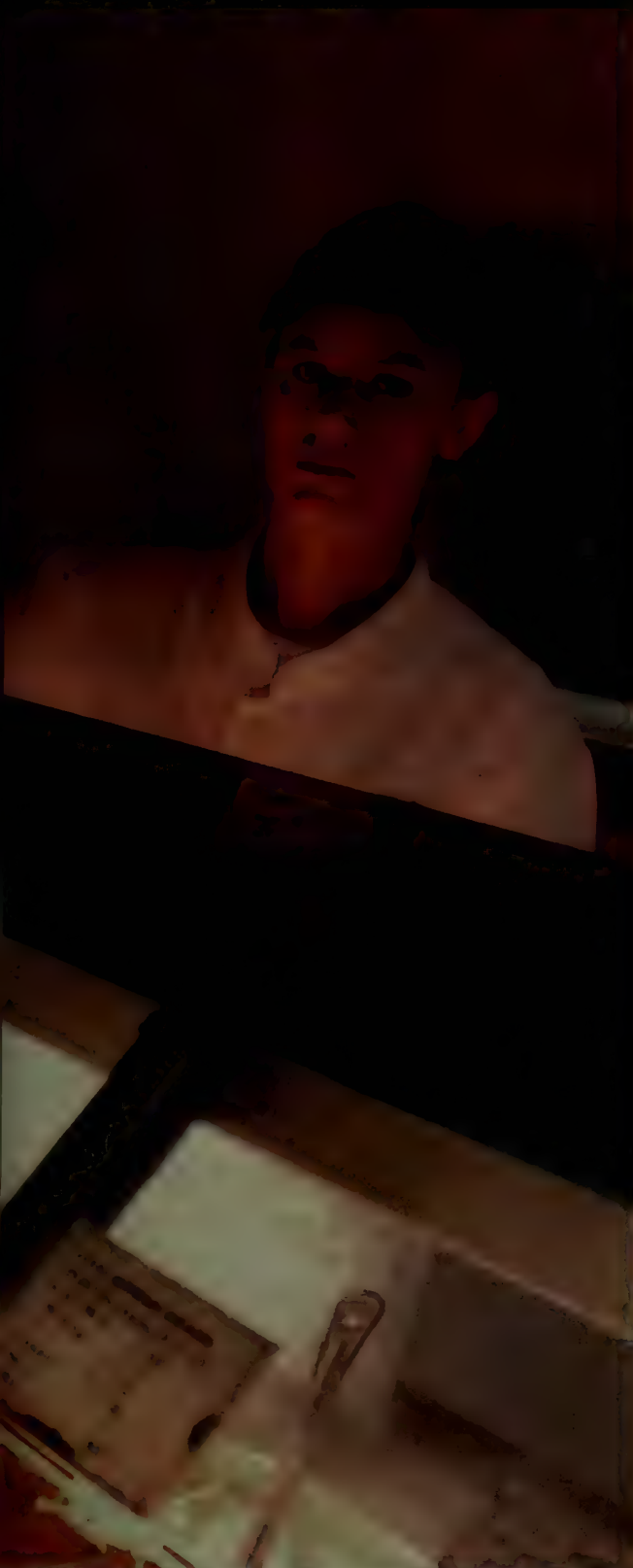
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An inside look
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PREPARING
TO CAP A
BURNING OIL
WELL IN IRAQ

BY ANTHONY BIANCO &
STEPHANIE ANDERSON FOREST

Early on the morning of Aug. 5, a U.S. mail convoy pulled out of the airport in Baghdad and headed north. A U.S. Army Humvee bristling with weaponry led the way, followed by three heavily loaded trucks, each driven by a civilian employee of Kellogg Brown & Root (KBR). A second military Humvee brought up the rear. Near Tikrit, Saddam Hussein's hometown, a bomb detonated under one of the trucks. The military police pried its driver, Fred Bryant Jr., from the wreckage and raced him to a military field hospital. Bryant, 39, died en route, the first KBR combat casualty since the Texas contractor was founded in 1919.

Bryant's death underscores the U.S. military's heavy reliance on private military companies, or PMCs, to wage war in Iraq. By most estimates, civilian contractors are handling as much as 20% to 30% of essential military support services in Iraq. Scores of PMCs are active all across the country, but KBR in particular has become indispensable to the global projection of American military might in this unsettled age. "It is no exaggeration to say that wherever the U.S. military goes, so goes Brown & Root," says P.W. Singer, a Brookings Institution fellow and author of *Corporate Warriors*. Widely known as Brown & Root, KBR is a unit of oil-services giant Halliburton Co.—Dick Cheney's old company.

KBR and its rivals figure crucially in the increasingly clamorous debate over the size and structure of America's armed forces. To save money, the U.S. has pared its roster of active-

Special Report

(L. TO R.) PHOTOGRAPHS BY JAMES HILL/GETTY IMAGES, GRAHAM MORRISON/NETWORK PHOTOGRAPHERS

WHERE THE U.S. MILITARY GOES, SO GOES BROWN & ROOT

To avoid the financial and political toll of hiking U.S. armed forces, the Pentagon has increasingly turned to KBR

duty troops by 32%, to 1.5 million, since 1991. But a not-so-funny thing happened on the way to the post-Cold War new world order: Terrorist networks proliferated, and long-suppressed ethnic conflicts broke out all over the globe, prompting the U.S. to intervene militarily. The Pentagon was able to maintain—and perhaps even boost—the potency of America's armed forces by developing an awesome array of new high-tech weaponry and replacing tens of thousands of soldiers with civilian PMC workers.

The Bush Administration was so confident of America's military superiority that it went into Iraq with a much smaller, more nimble force than the huge multinational coalition that was assembled to push Saddam out of Kuwait in 1990. The swift defeat of the Iraqi army seemed to invalidate the Powell Doctrine, which holds that the U.S. should fight only when it has an overwhelming numerical edge. But occupying Iraq with 140,000 U.S. troops (plus 21,700 from Britain and other countries) is proving another matter altogether, putting the new contractor-dependent military to its most severe test to date.

Special Report

force of 300,000 to 500,000 soldiers to pacify Iraq. But even if the U.S. wanted to substantially boost troop levels, it's not clear where reinforcements would come from. About 50% of the Army's active-duty troops are on foreign soil already, and in many key military specialties, the deployment percentage is much higher. For example, 90% of all American military police are already on active duty. With U.S. troops tied down in terrorist-hunting and peacekeeping missions from the Philippines to Liberia to Uzbekistan, America's downsized armed forces are stretched thin—perilously so, say many experts.

The era of military shrinkage clearly has ended, yet the Bush Administration is resisting calls to begin expanding the Army again. Instead, Defense Secretary Donald H. Rumsfeld is weighing a series of measures designed to increase the potency of America's armed forces without incurring the expense—financial and political—of putting more Americans in uniform. In essence, Rumsfeld wants the Pentagon to make

HUNGARY	
TASZAR AIR BASE	\$287.7
BOSNIA & HERZEGOVINA	
EAGLE BASE	
CAMP McGOVERN	\$695.2
KOSOVO	
CAMP BONDSTEEL	
CAMP MONTEITH	\$829.2
MACEDONIA	
CAMP ABLE CENTURY	\$30.5
TURKEY	
INCIRLIK AIR BASE	\$100.0
JORDAN	
BASE CAMP	\$39.3
DJIBOUTI	
CAMP LEMONIER	\$28.0



more effective use of existing resources. Above all, means substituting even more civilians for troops and leaning even more heavily on PMCs. There are "something in the neighborhood of 300,000 men and women in uniform doing jobs that aren't for men and women in uniform," Rumsfeld said during Senate testimony in July.

No company is better positioned to take over those jobs than KBR. Over the past decade, the company has housed, fed, and maintained American fighting forces in some of the most geographically remote and politically dangerous regions on earth. It has proven itself capable of efficiently mobilizing its own vast army of engineers, cooks, and logistics experts, often on short notice. Even rival PMCs generally praise it as an adept and reliable operator. "They have a good performance record," says Albert J. Konvicka, president of AECOM Government Services Inc., a Fort Worth-based PMC. "They can react very quickly to situations. I respect them as a competitor."

But outsourcing is no panacea for America's overextended military. Brown & Root and most other PMCs work steadily in a supporting role. Their employees maintain American high-tech weapons and train soldiers how to use them. They depend heavily on their military customers for protection in combat zones. If security breaks down, as it often has in Iraq, the PMC support system is liable to malfunction. Lieutenant General Charles S. Mahan Jr., the Army's top logistics officer, recently complained that so many civilian contractors had refused to deploy to particularly dangerous parts of Iraq that soldiers had to go without fresh food, showers, and toilets for months. Even mail delivery was weeks behind, Mahan complained in a July 31 interview.



A SAMPLING OF KEY LOGISTICS AND OPERATIONS CONTRACTS, FROM THE BALKANS TO CENTRAL ASIA
(IN MILLIONS, EXCEPT WHERE NOTED)

- BALKAN SUPPORT CONTRACT*
- TURKISH BASE-MAINTENANCE CONTRACT*
- LOGCAP, OR LOGISTICS CIVIL AUGMENTATION PROGRAM**

*ACTUAL COSTS INCURRED FROM 1999-2002 PLUS PROJECTED COSTS FOR 2003 AND 2004
**MAXIMUM SPENDING ALLOWED

Source: Transatlantic Programs Center, U.S. Army Joint Munitions Command & Army Field Support Command

GEORGIA
MILITARY TRAINING MISSION **\$25.1**

UZBEKISTAN
CAMP STRONGHOLD FREEDOM **\$22.1**

AFGHANISTAN
BAGRAM AIR FORCE BASE **\$38.8**
KANDAHAR BASE CAMP **13.4**
AFGHANI WATER WORKS **10.0**

IRAQ
OIL-FIELD REPAIR (BILLIONS) **\$7.0**
PRISONER-OF-WAR CAMPS **28.2**
SUPPLY LINES **122.0**
FOOD AND SHELTER FOR ORMA*
AND DEFENSE INTELLIGENCE
AGENCY TASK FORCE **210.8**
FOOD AND SHELTER FOR
100,000 TROOPS **160.0**
SUPPORT FOR
POLISH FORCES **92.0**

*OFFICE OF RECONSTRUCTION & HUMANITARIAN ASSISTANCE

KUWAIT
CAMP ARIFIAN **\$36.9**
KUWAIT BALLPARKS **25.0**
SEAPORT OF DEBARKATION **30.0**
AIRPORT OF DEBARKATION **105.0**

voritism. Although Cheney no longer owns stock in Halliburton, he was its chairman and CEO for five years and either hired or promoted many of the executives now running Halliburton and KBR. At the insistence of two powerful House Democrats, Henry A. Waxman of California and John D. Dingell of Michigan, the General Accounting Office, the investigative arm of Congress, is looking into the issue of whether KBR has received special treatment in the awarding of Defense Dept. contracts over the past two years.

David J. Lesar, Halliburton's current chairman and CEO, is exasperated by the

Newhouse News Service. "We thought we could depend on industry to perform these kind of functions," Mahan says. "But it got 'harder and harder to get [them] to go in their way.'"

General Mahan didn't knock Brown & Root by name. He just had to; the company is by far the biggest services contractor in Iraq, with more than 2,500 employees in Central Asia and the Middle East as a whole. U.S. Civil Administrator L. Paul Bremer III and the 1,000-person Office of Reconstruction & Humanitarian Assistance depend on the company for food and shelter, as do at least 100,000 of U.S. troops stationed in Iraq. In addition, the U.S. Army Corps of Engineers turned to KBR and KBR alone to repair damaged oil wells and pipelines and get Iraqi oil—the key source of reconstruction revenue—flowing back to export markets.

For its work in support of the invasions of Iraq and Afghanistan, KBR has billed the U.S. government about \$950 million for work completed under contracts capped at \$8.2 billion. At the same time, KBR is in line to earn tens of millions of dollars more to maintain the archipelago of U.S. military bases that now arcs from the Balkans south to the Horn of Africa and east to Afghanistan and Kyrgyzstan. Closer to home, KBR built the detention camps in Guantanamo Bay, Cuba, that house Taliban and al Qaeda prisoners. All in all, no corporation has played as central a role in America's global anti-terrorism campaign—or profited as handsomely from it—as KBR.

The company's high-profile success in winning contracts, coupled with its intimate ties to the White House, has fueled suspicions that it is a beneficiary of political fa-

controversy swirling around his company. "Despite some of the media scrutiny you've seen, within the organization we are very, very proud of what we do to support the military and, I think, save the U.S. taxpayer some money," says Lesar, who insists that all of KBR's dealings with the Pentagon have been at arm's length.

Robert "Randy" Harl, KBR's president and CEO, insists that General Mahan's complaints do not apply to KBR. The company "has met every commitment we have made to the military," Harl says. "Our company has no higher priority than to support our military on the ground." Mahan was unavailable to discuss his criticisms of civilian contractors with *BusinessWeek*; the 57-year-old three-star general retired from military service shortly after making his comments. A Pentagon spokesman declined to comment.

Mahan's departure will do nothing to quell the debate over the military's rising dependence on Brown & Root and other PMCs. There is general agreement that it makes sense to shift troops out of jobs that contractors can handle at least as well—and probably at less cost—and let them concentrate on purely military tasks. "The cost-savings argument for outsourcing is not nearly as compelling as the potential improvement from quality of service or flexibility," says Steven L. Schooner, co-director of government-procurement law at George Washington University Law School.

The outsourcing trend also is being driven by the accelerating sophistication of military software and hardware. The high-tech weapon systems used to such devastating effect in Afghanistan and Iraq are so complex that combat units in the field have no choice but to depend on expert civilians to maintain and, in some cases, operate them. The F-117 stealth

AFGHANISTAN The State Dept. pays Dyncorp to guard President Karzai

fighter, M1A1 tank, Patriot missile, and Global Hawk unmanned drone are all heavily contractor-dependent.

Skeptics, who include many members of the military Establishment, warn that the growing PMC presence on the battlefield exposes America's armed forces to potentially catastrophic risk. As civilians, contract employees are not subject to military command and discipline. Workers who refuse an assignment can be fired by their employers but not tossed into the brig. The Pentagon's only recourse is to sue—no comfort at all to a commander in the field who has been left in the lurch by vanished contractors. A PMC's ultimate duty is not to its military customers but to its shareholders. "Contractor loyalty to the almighty dollar, as opposed to support for/of the front-line soldier, remains [a] serious question," warned a U.S. Army War College paper last year.

Special Report

Although the ultimate interests of the military and the PMCs diverge, their routine dealings are defined by cooperation, not conflict. The emergence of a robust private military industry has set the revolving door between the Pentagon and private industry spinning faster than ever. From top to bottom, the typical PMC is heavily staffed by ex-military officers. "Roger that," replies



Billy J. Gray, a well-traveled KBR manager now stationed at Camp Bondsteel in Kosovo, when asked if he is ex-Army. Like many of his colleagues, Gray gets a bigger paycheck from KBR than he did in his Army days, and he still gets a military pension, which, for a veteran with 20 years' service, amounts to 50% of his old salary.

Military Professional Resources Inc., an Alexandria, Va., military consulting firm, boasts of having "more generals per square foot than the Pentagon." But no PMC has forged a more intimate connection with America's warfighters than Brown & Root, whose forté is building and maintaining military bases in dangerous places. At locations such as Camp Bondsteel and Camp Arifjan in Kuwait, KBR employees often live with the soldiers—albeit within a separate



KOSOVO PMC (left) and U.S. Army personnel

THE CORPORATE MILITARY

Kellogg Brown & Root is the best-known private military company (PMC) in the world, but it has many competitors. Here is a brief look at four of the most prominent players:

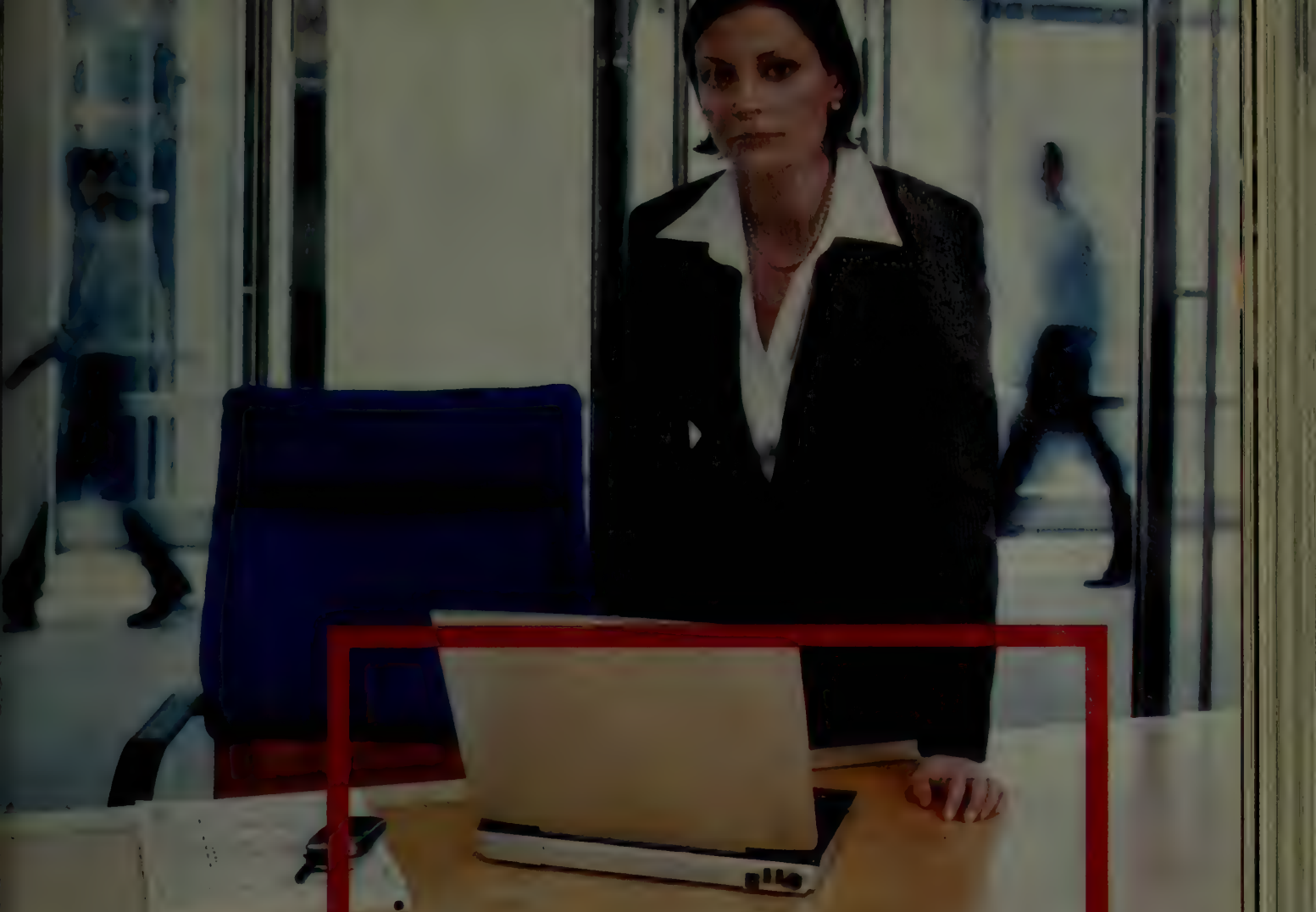
DYNCORP The most broadly diversified PMC, Dyncorp posted \$2.3 billion in revenues in 2002. Under contract to the State Dept., it provides bodyguards for Afghan President Hamid Karzai and recently sent 1,000 ex-cop and security guards to Iraq to help train a new police force. Information Technology consulting giant Computer Sciences acquired Dyncorp in 2002 for \$950 million.

VINNELL Vinnell, which was acquired last year by Northrop Grumman, has trained the Saudi National Guard since 1975 under a contract currently valued at \$800 million. In May, 10 of Vinnell's employees

perished in a suicide-bombing attack on a housing complex in Riyadh. Vinnell bested four other bidders for a \$48 million contract to train the nucleus of a new Iraqi army.

MILITARY PROFESSIONAL RESOURCES Founded in 1988 by eight former senior military officers, MPRI boasts of having "more generals per square foot than the Pentagon." It took over the administration of much of the Army's Reserve Officer Training Corps program and played a vital role in the Balkans by helping Croatia and Bosnia create professional armies. MPRI was acquired by high-tech-weapons maker L3 Communications in 2000.

AECOM GOVERNMENT SERVICES A division of Los Angeles-based AECOM Technology, AECOM heads a joint venture company called Combat Support Associates. In 1999, CSA won a \$900 million, 10-year contract to provide logistics and support services to the Army Forces Central Command in Kuwait. CSA employs 3,000 workers at Camp Doha, a key staging area for the Iraq invasion.



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Vinnell workers died in a Riyadh bombing

pound on the base—thereby alleviating the privations while sharing many of the dangers of military life. Says GWU's Schooner: "Brown & Root has won the hearts, minds, and stomachs of everybody in the military."

Unlike soldiers, however, KBR employees have the option of quitting at any time. "I've raised my hand before and said, 'Guys, I'm burned out,'" says Gray, an engineer who oversees vehicle maintenance and electric-power generation at Bondsteel. Gray, who has worked for KBR for a decade, has taken three home leaves over the years. He just returned to work in April after a nine-month break. "I called up and said, 'Hey, I'm deployable again,'" he says.

The Defense Dept. is the private military industry's biggest customer, but hardly the only buyer in what is a truly global market. Great Britain and other established military powers have embraced military outsourcing to varying degrees, while numerous Third World countries have hired PMCs to train their armies and in some cases—Sierra Leone, Angola, the



very much with us—especially in Africa—but they tend to operate in small, ragtag units of limited effectiveness. In short, they cannot begin to compete with PMCs, which have minimized the military-services business by reorganizing it in corporate form. Scrupulously avoiding the shadowy, booting margins of the business, KBR acts only as a work partner of the armed forces of the U.S. and its allies, not as their proxy. In addition, the company shuns all assignments that require carrying weapons, including sentry duty at military bases, a PMC staple.

Brown & Root's military-contracting operation is a continuation of the company's original business: engineering and construction. During World War II, Brown & Root landed its first military contracts and eventually built hundreds of ships for the U.S. Navy. Its employees accompanied troops to Korea and Vietnam, building bases, roads, harbors, and so on. In 1963, Brown & Root sold out to oil-services giant Halliburton (becoming Kellogg Brown & Root with the addition of oil-pipe fabricator M.W. Kellogg in 1998). Taking its cues from Halliburton, KBR emphasizes energy projects, exiting the military business altogether when the U.S. withdrew from Vietnam in 1973.

Desperate for new sources of revenue during the cyclical oil-industry contraction of the mid-1980s, KBR turned back into military contracting in 1987—this time to stay. "We see it as a very nice adjunct to the rest of the business," says Halliburton CEO Lesar. "It requires many of

the same capabilities that we have to execute our basic strategy, which is serving our oil and gas customers: good engineering, good logistics, the ability to get people on the ground fast, the ability to handle enormous amounts of data."

Military contracting now accounts for only about 20% of KBR's revenues—which is unfortunate for shareholders, since the business is the best thing the beleaguered unit has going for it. Over the past 12 months, KBR incurred operating losses of \$6.1 million on revenues of \$6.1 billion. The company is so weighed down by asbestos-related li-

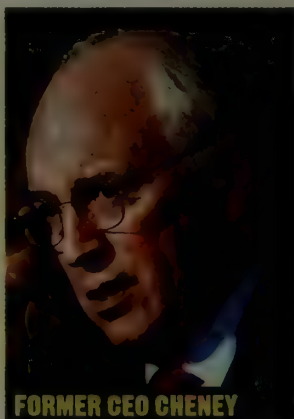
Special Report

Congo—to literally fight their battles.

Brown & Root ranks among the five top defense contractors in the United Kingdom. Since 1997, KBR has owned a 51% stake in the Davenport Royal Docks, a former government facility where the company and its two English partners maintain the Trident fleet of nuclear submarines. In late July, the Ministry of Defense named a consortium led by Brown & Root as the preferred bidder for a 4 billion-pound, 30-year contract to upgrade British Army garrisons housing a total of 18,000 soldiers and civilians.

Everyone agrees that the global PMC business is booming, but no one knows exactly how big it is. A two-year study completed in 2002 by the International Consortium of Investigative Journalists identified 90 PMCs operating in 110 countries. U.S. companies dominate, but sizable PMCs operate out of Britain, South Africa, Russia, Israel, and elsewhere. Many PMCs are privately owned, and even the ones that are part of publicly held corporations, such as KBR, tend to provide minimal financial detail. Much of the work PMCs perform is classified "secret" by their government clients. But for many of them, reclusiveness also is a public-relations strategy. The private military industry has an image problem reducible to a single, rather dirty word: mercenary.

The tradition of hired foreign guns is older than the gun, dating to ancient times. The Geneva Conventions of 1949 criminalized the mercenary trade, driving it underground. Mercenaries are still



FORMER CEO CHENEY

The Vice-President was KBR parent Halliburton's boss from 1995 to 2000



CURRENT CEO LESAR

"We... save the U.S. taxpayer some money," says Halliburton's chief

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KUWAIT Camp Arifjan, built and maintained by KBR

ties incurred by its construction business that it plans to file for Chapter 11 bankruptcy this fall to settle pending personal-injury claims. KBR's government-contracting unit will not be included in the Chapter 11 filing.

In this year's second quarter, KBR earned \$17 million on the \$292 million in revenue produced by its work in Iraq, a paltry margin of 5.8%. On the other hand, the military business is reliably profitable and far less capital-intensive than either oil services or construction because the government owns virtually all the fixed assets. Under the "cost-reimbursable" contracts common in military logistics, KBR passes along 100% of its costs to the customer and is assured of a 1% profit. In addition, the company can earn an "award fee" of 1% to 8% of total expenditures depending on how well it performs.

The bulk of KBR's military business has come in through a single, infinitely expandable contract called the Logistics

Civil Augmentation Program, or LOGCAP for short. When Brown & Root won

Special Report

the first LOGCAP contract in 1992 over three other bidders, no one imagined that it would burgeon into what the Contract Services Assn. calls "the mother of all service contracts." For a fee of \$3.9 million, LOGCAP I required KBR to develop contingency plans for deploying U.S. forces to 13 different parts of the world. But LOGCAP was more than brainwork: The company had to be ready, on short notice, to transport a fighting force of up to 50,000 troops to any location in the world and to supply them with food and other essentials for as long as six months.

Brown & Root was called into combat for the first time in late 1992, accompanying U.S. forces into Somalia in support of a U.N.-sponsored intervention. Soon, KBR was Somalia's largest employer, with 2,500 locals on the payroll. The Army paid the company \$110 million for Somalia and \$141 million to assist 18,000 troops sent into Haiti on another U.N. mission in 1994. But it wasn't until the U.S. led NATO forces into Bosnia in 1995 that KBR—and the entire private military industry—came of age.

Limited by Presidential order to calling up no more than 4,300 reservists, the Army turned to Brown & Root and scores of other contractors. During one of the harshest Balkan winters on record, KBR joined with military engineers to create 34 bases from former U.N. camps, abandoned factories, ruined buildings, and open fields. The company supplied most of the building materials needed because it was able to make deliveries faster than the Army could, according to a GAO report. The 16,200 soldiers who filled the camps depended almost entirely on KBR for food and other necessities.

KBR's LOGCAP agreement expired in 1997, and the U.S. Army Material Command awarded a new five-year contract to rival Dyncorp. "Losing that was quite a blow," Harl concedes. "We turned in a proposal that was not fully responsive to what [the AMC] was looking for." The Army softened



the blow considerably by carving out the Balkans under a separate contract given to Brown & Root. The company continued to operate in Bosnia—and moved south into Kosovo with the Army when war erupted there in 1999. In short order, KBR built three more large bases and scores of peripheral outposts.

Through 2002, the Army has paid KBR about \$2.5 billion for its work in the Balkans. Neither the company nor the Army will disclose how much of this is profit. An Army spokeswoman says that on average, KBR has received about 90% of the maximum fee award of 8% to 9%. This works out to a profit of about \$200 million. In recent years, the U.S. sharply reduced its troop levels in the Balkans and closed most of its bases. KBR continues to run the bases that remain and is projected to receive \$367 million more in payments next year and next, when its contract expires.

The Army's spending in Bosnia repeatedly exceeded expectations, attracting intensive scrutiny in Washington. However, in 1997, a Logistics Management Institute study found that it would have taken 8,918 troops and \$638 million to do what KBR's 6,766 employees had done for \$462 million. "When compared with the costs of using an equivalent military force," the study concluded, "the use of LOGCAP contractors is economical."

The big savings is in labor costs. A PMC does not have to pay the cost of training and deploying a soldier. It also subcontract out to local workers—"host country nationals" is the parlance of the trade—at much lower rates than the U.S. government scale. For example, in the Balkans, KBR paid carpenters, electricians, and plumbers \$15.80 an hour on average, compared with the \$24.38 government rate. The wage gap was largest for basic laborers: \$1.12 an hour vs. \$15.99.

Still, the GAO, which twice investigated LOGCAP spending in the Balkans, chided the Army for the laxity of its oversight of contractors' cost-plus spending. "Army and other [Defense Dept.] officials have typically accepted [KBR's] judgment and not questioned the level of services being provided," the GAO noted in a 2000 report entitled *Army Should Do More to Control Contract Cost in the Balkans*. The agency gave KBR high marks, the report continued, but noted that military officials often were unable "to explain the frequency of services being provided, such as...clean latrines three times a day."

In 2001, KBR outbid Dyncorp and another company to win back the LOGCAP contract, now extended to a duration of

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FORESIGHT War hero and four-star General Eisenhower bid adieu with a warning

years. Under LOGCAP, KBR has received assignments potentially worth as much as \$183 million to support the hunt for al Qaeda and other terrorist operatives in Afghanistan and neighboring countries. The company maintains the two biggest bases in Afghanistan—at Bagram and Kandahar—and Camp Stronghold Freedom in Uzbekistan. Meanwhile, Operation Iraqi Freedom has sent \$1 billion more in LOGCAP business KBR's way to date, and new work orders still are being issued at the rate of a half-dozen per month.

In late 2002, the Pentagon asked KBR to grapple with a question complicating U.S. plans for invading Iraq: What to do if Saddam torches his own oil fields, as he did Kuwait's during the last Gulf War? KBR drew up a classified contingency plan to deal with this nightmare scenario. The work was done under LOGCAP, but to help implement the plan, the Army Corps of Engineers signed KBR to a separate contract capped at \$7 billion.

General Robert Flowers, the Corps' commander, said the contract was awarded to KBR because the Army had complete confidence in the company and there wasn't time to put it out to bid—an explanation that inflamed suspicions that the political fix was in.

Special Report

Harl emphatically denies it. "Our people did a great job in securing that work, and Dick had nothing to do with it," Harl insists. Bill Allison of The Center for Public Integrity, a Washington-based government watchdog group, argues that Cheney does not have to actually pull strings to help his old company. "Cheney knows how things work," Allison says. "There are a number of ways you can help without actually being involved."

As it turned out, Saddam's forces set fire to only 9 of Iraq's 1,821 oil wells. But in the months since the U.S. captured Baghdad, saboteurs have done heavy damage to oil wells, pipelines, and other facilities throughout the country. This massive repair job has fallen to Task Force RIO (Restore Iraqi Oil), which consists of some 300 Brown & Rooters and a smaller Army Corps of Engineers contingent. KBR has finished \$705 million worth of this work to date. The money will keep rolling in for another few months but likely will fall well short of \$7 billion—a figure that presumed an oil-field conflagration of apocalyptic scope. KBR's contract, which was always intended as a stopgap measure, will be replaced at yearend by two new contracts, each potentially worth \$500 million, according to the Corps of Engineers. KBR is an odds-on bet to win one but not both contracts, if only because a double victory likely would provoke Waxman and Dingell to new heights of outrage.

Lesar expects KBR to remain an opportune political target for as long as Cheney occupies the White House. "That's just part and parcel of living with who my predecessor was," he says, adding that no amount of contention will dissuade KBR from pursuing new military business. "If I believe there is a piece of work out there that we have the capability to do," Lesar says, "I have an obligation to my shareholders to go after it."

With Stan Crock in Washington and Thomas F. Armistead in



In coining the term "military-industrial complex" in his farewell address to the nation in 1961, President Dwight Eisenhower—retired four-star general and war hero—warned of the incestuous ties that had formed between the Defense Dept. and the "permanent armaments industry" birthed by World War II. Eisenhower worried the Pentagon's pursuit of its bureaucratic imperatives combine with arms makers' pursuit of profit to thrust the U.S. into a war the country did not need and perhaps not win.

The big weapons manufacturers that alarmed Eisenhower have shrunk in number and size since the Cold War ended. But the emergence of the private military contractor has extended the relationship that so worried Eisenhower, pushing it beyond the executive suite and factory floor to the battlefield itself. The PMCs' adaptability is politically well as militarily useful to the government. Why take the heat of calling up reservists when you can summon civilians for-hire? Why try to persuade Congress to sanction the use of U.S. troops in Colombia's war on narco-guerrillas when you can send in contractors to spray coca fields? train paramilitary groups—as both the Clinton and Bush administrations have done?

The new military-industrial complex seems to pose at least as much danger to itself as it does to society. Private contractor no-shows in Iraq have jolted U.S. military leaders who expected a repeat of Brown & Root's yeoman performance in the Balkans. Says Brookings Institution's Singer: "Now that the Army's eyes have been opened to this, they are thinking through other scenarios, with war in Korea being not only the most likely but the most worrisome possibility."

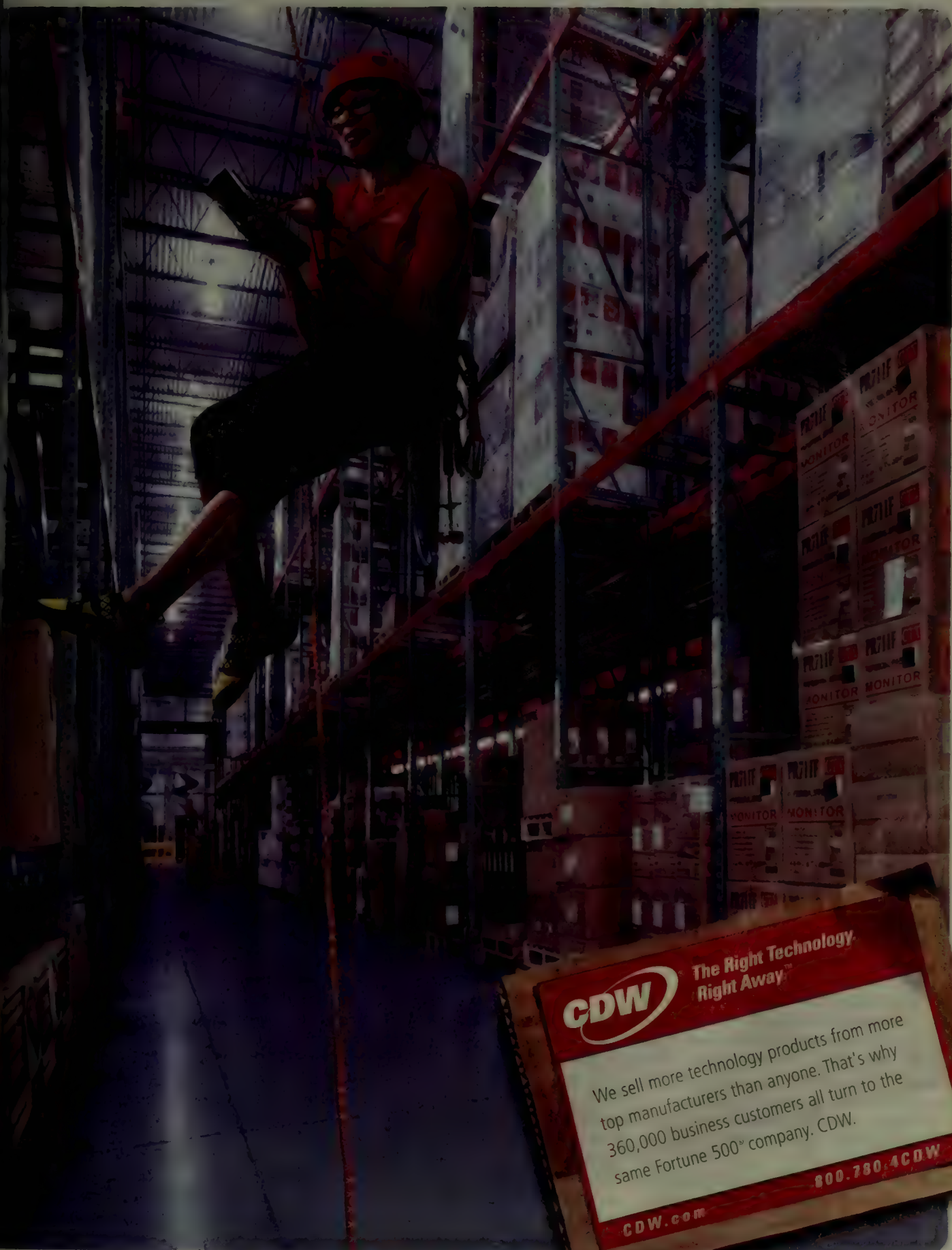
If conditions in Iraq continue to deteriorate, plenty of other people will be focused on whether the policy of replacing soldiers with private contractors, even in support roles, is taken too far. The ultimate fear, of course, is that contractors under extreme duress will flee en masse, exposing U.S. soldiers to catastrophic risk—a disastrous outcome that even Eisenhower foresaw.

With Stan Crock in Washington and Thomas F. Armistead in

BusinessWeek online

For Q&As with Lesar and Harl, go to
www.businessweek.com/magazine/extra.htm

10:32 am. Martha Watson fills an order for one of CDW's 360,000 business customers using her own, signature style.

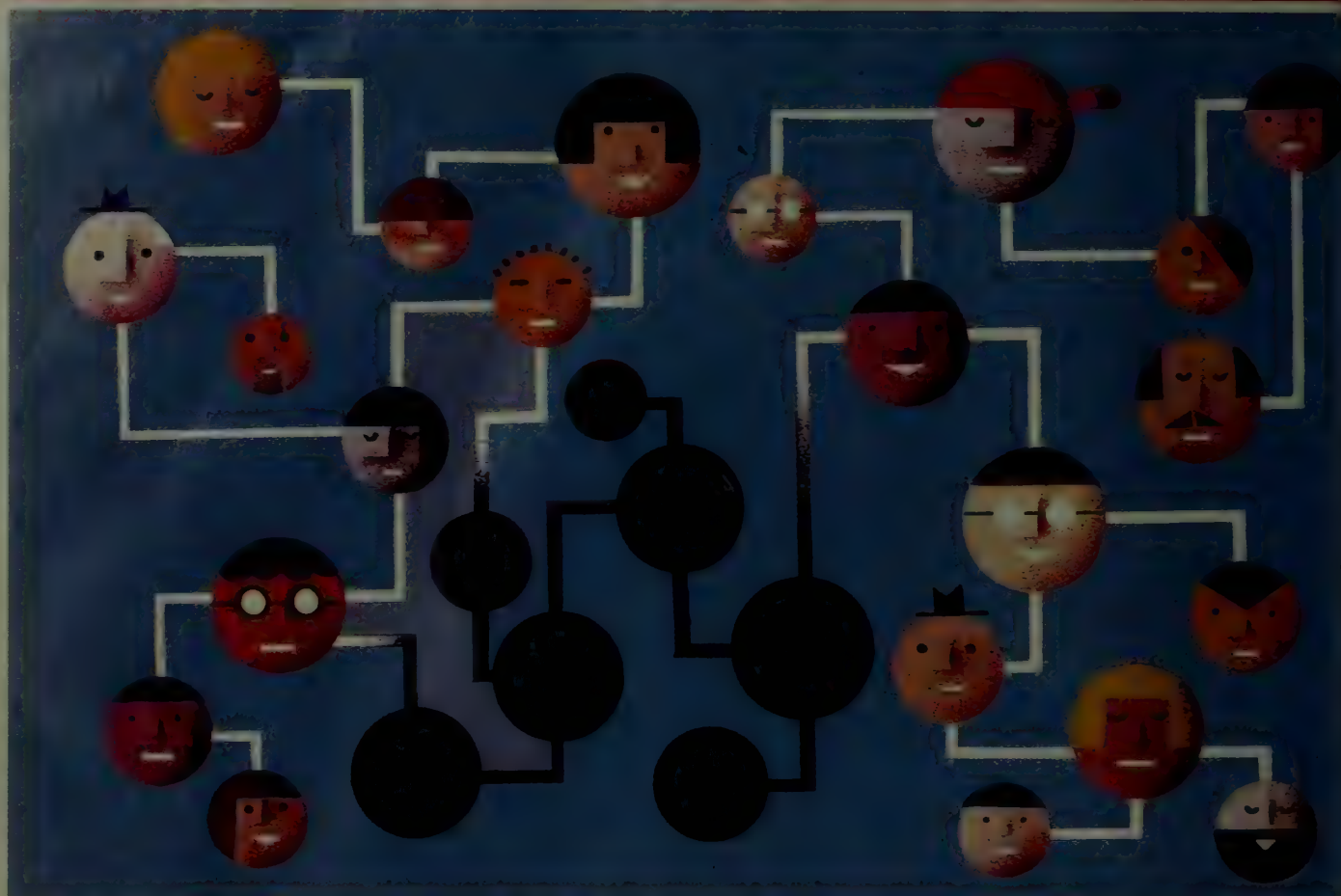


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CYBERSPACE

THE UNDERGROUND INTERNET

Members-only "darknets" are popping up to protect file-sharing from prying eyes

Around the time the Recording Industry Assn. of America said this spring it would start tracking down individuals who were trading pirated music on the Internet, Trader X, a 17-year-old U.S. high school senior who declined to provide a name to avoid prosecution, hightailed it over to a service for swapping music and other digital files called Direct Connect (DC). Trader X had used other file-sharing services in the past, but chose DC for two simple reasons: privacy and plenty of movies. In most file-sharing services, millions of computers swap files with millions of others openly online, in plain view of the RIAA and others. DC's free software lets individuals set up a password-protected, members-only network that relays music and movies among a

closed group of people. "Frankly, as long as the Internet exists, file trading can't be stopped," says Trader X.

This is just one glimpse into the world of darknets—gated communities that run on the Internet but are open only to those who belong to the private network. These mini-networks are gaining appeal among more than just teenagers looking for a free copy of rapper 50 Cent's *21 Questions*. Political dissidents from China to Iran, as well as civil libertarians in the U.S., are interested in avoiding the prying eyes of government authorities and reestablishing some privacy on the transparent Internet. Even well-respected corporations, including Hewlett-Packard Co. and Siemens, are turning to darknets to allow them to share sensitive data

with outside partners while protecting the data from rivals and restricting partners from burrowing into the corporation's own intranet.

How do darknets work? Typically, people who want to build a darknet start by installing on their computers specialized software, which they can often download for free from the Internet. Then individuals who want to form their own group swap passwords or digital keys so their computers can communicate with each other. The shuttling between computers often is encrypted, a security feature similar to that used for online credit-card transactions. This makes darknets more secure than typical corporate intranets, since companies usually don't encrypt data. Anyone tracking the private



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works could monitor the traffic, but wouldn't know what information was inside the encrypted packets. And gaining entry to a group of, say, college kids swapping music is no easy feat: Prospective members often need recommendations from friends to join.

It's a sweeping revision of the notion of the open Internet. Netizens are walling themselves off for certain activities like never before. Darknets are very different from the typical corporate networks, monoliths built to last for years. These networks are designed to be put up and taken down quickly and easily, so they can be used for a week or a year. Teenagers could establish a darknet to trade music—and take it down as soon as they feel pressure from authorities by simply removing the software from their machines. GlaxoSmithKline PLC is using a darknet so chemists, biologists, and others in-house and at some universities can share information for the development of an obesity drug.

Innovation in darknet technology is coming from many different directions. Independent developers are giving away Freenet and invisibleNET, software that allows dissidents in countries where censorship exists to get information from the outside world and speak more freely among themselves. A free program called Waste, designed by America Online's Nullsoft division, showed up on the Web four months ago and is catching on among pirated-music dealers. BadBlue and Groove Networks Inc. are among the companies trying to make money from darknets. They sell collaboration software that permits a company to safely share sensitive documents or financial information with partners.

Trust among members is the critical ingredient for certain darknets, including those using technology from Waste and DC. DC is less secure than Waste because the software giving access to the main computer that runs the network is simply password-protected. If someone infiltrates a group, that person can track everything that's going on within the hub. Waste is more secure. It uses encryption to protect files and messages sent among the members of a private network, called a mesh. To join a mesh, a member exchanges encryption keys with someone in the network. Although AOL quickly yanked the software off Nullsoft's site, programmers with copies

downloaded from the Web are busily enhancing it. Devotees predict the technology will blossom. "Waste will only improve over time as more users and developers adopt it," says Tom, a 22-year-old programmer who has set up one mesh for family photos and news and another for software development.

Freenet's emphasis is on anonymity through technology, not trust. The brainchild of Irish programmer Ian Clarke, Freenet works by tying together computers around the Internet through strong encryption. Freenet organizes a bucket brigade of computers that dedicate a portion of their hard drives to encrypted data and only talk to their nearest neighbor on the network. When a request for some bit of information is made, each computer

Inevitably, as the pressure mounts on illegal copying, people interested in private file trading are seeking out private networks. Since the RIAA started targeting individuals who are sharing monthly revenues

BadBlue's software designed for small-scale use, which costs between \$30 and \$60, have increased about 50 percent, says Doug Ross, the company's technology officer. Moreover, Clarke says that Freenet downloads have tripled during the past four months to a total of about 2 million. "As soon as [the RIAA] laid down those individual subpoenas, we started deleting posts from people looking for private networks," says Chris Hedgecock, president of ZeroNet Inc., a site where about 160,000 sharers discuss news and exchange information. The entertainment industry is worried about these digital versions of Prohibition-style speakeasies are of

DARKNETS RISING

There are plenty of reasons people turn to private file-sharing networks, including fleeing the music industry's watchdogs. Here is a sampling:

FREEDOM OF SPEECH Independent developers have created free software, such as Freenet and invisibleNET, that establishes anonymous networks on the Net so dissidents in countries including China, Turkey, and Iran, can express their political views safely.

CORPORATE SECURITY Software startups, including BadBlue and Groove Networks, sell file-sharing software that lets corporations create closed networks over the public Internet. It can be used by developers to securely share software code they're working on or by companies to discuss business deals.

COPYRIGHT INFRINGEMENT Free peer-to-peer software, such as Direct Connect and Waste, can be used to bring together vetted, closed groups, often of no more than 50 people, who share music, movies, software, even Japanese anime characters.

queries its neighbor to determine if it has that information. If not, the request is passed to another neighbor that the first computer doesn't know about. Freenet-China, a Mandarin translation that has been up for a year and a half, publishes news that the Chinese government would censor and allows dissidents to read banned sites, such as CNN.com. "The Internet doesn't really have all that much anonymity now," says Clarke. "People are looking for ways to share information without being watched."

market trading of pirated music is too early to tell how popular these networks could eventually be, but groundwork is already being laid to come those fleeing the public works—for all kinds of reasons.

By Heather Green in New York

BusinessWeek online

To read more about the Nullsoft team behind Waste, go to www.businessweek.com/magazine/extra



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THE \$140,000,000 MAN

What Dick Grasso's excessive payout reveals
about how he runs the New York Stock Exchange

BY GARY WEISS

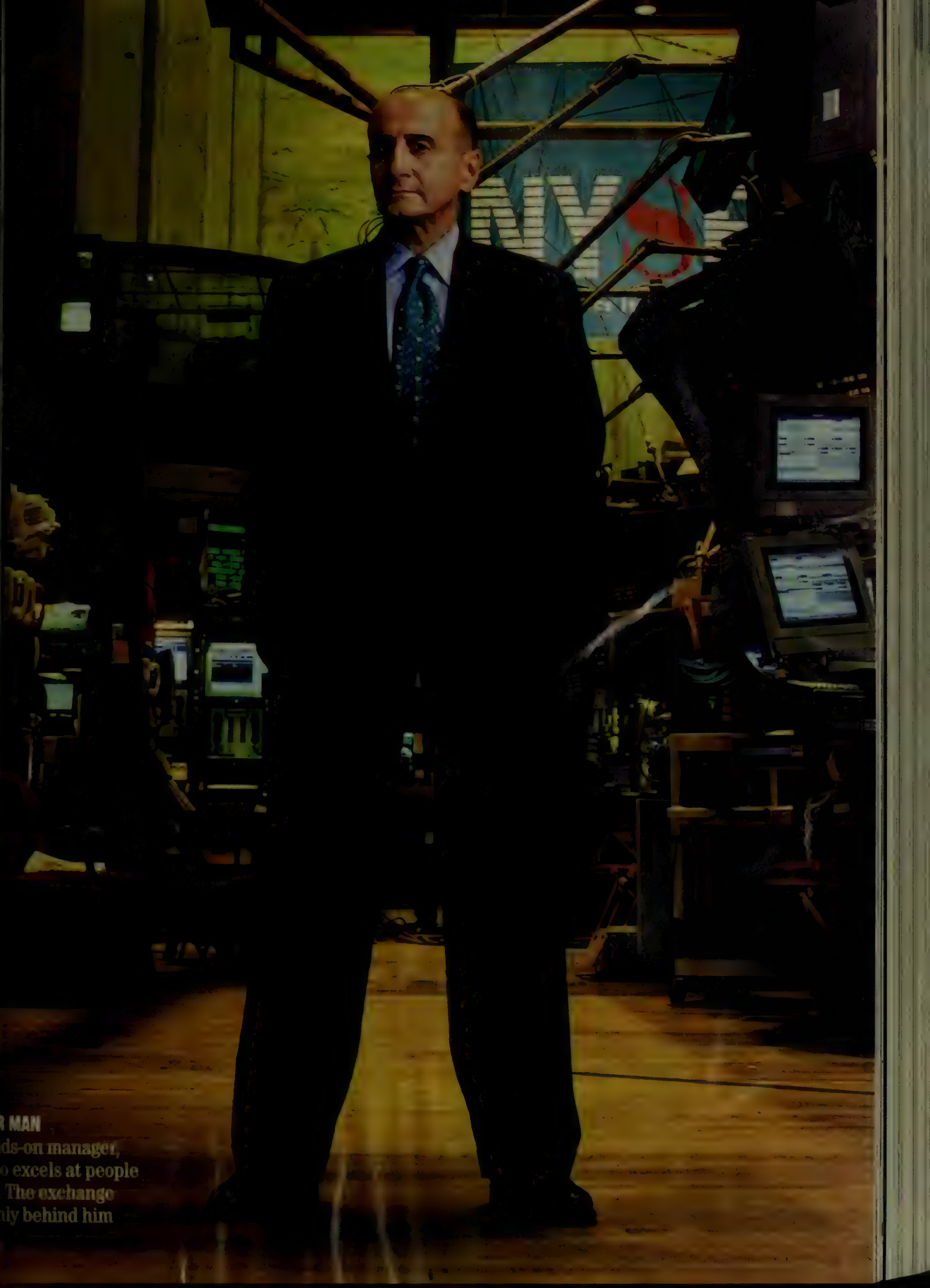
It is as vital a ritual as the ringing of the opening bell, but no celebrities are present, save one—Richard A. Grasso. At about 7:30 every morning, the chairman and CEO of the New York Stock Exchange is handed a set of papers at his desk on the sixth floor of 11 Wall St. This 57-year-old, wiry, bald man is the best-known—and notoriously the best paid—stock market executive in the world. Ever since it was announced on Aug. 27, his \$140 million compensation package has been a subject of intense criticism—and an investigation by the Securities & Exchange Commission. But no matter how bad the sniping from that and other crises, the numbers on those daily pages are solid, consistent—and reliably glorious.

The papers have no special name—"my overnights," he calls them—but they explain why Grasso is Wall Street's

\$140 million man. They are market-share statistics for the top 100 NYSE-listed stocks. For years, the NYSE's share trading in its listed stocks has been 80% or better—extraordinary performance, considering the growing number of competitors that face the NYSE. The comparable figure for the NASDAQ market is just 16.4%.

To Grasso's detractors, what matters most is not financial performance but his moral leadership—and in that realm, they maintain, Grasso is sorely wanting. On Sept. 1, SEC Chairman William H. Donaldson fired off a letter mandating that the NYSE explain, in detail, how it determined Grasso's pay package. And as if to drive home the point, the SEC released the letter, which contained an extraordinary public bawling-out of a sitting NYSE chairman. "In my view," Donaldson wrote, "the approval of Mr. Grasso's pay package raises serious questions regarding the effectiveness of the NYSE's current governance structure."

Even before the paycheck bombshell, institutional investors were going public with long-festered complaints

A full-page photograph of a man in a dark suit and patterned tie standing in a dimly lit control room. He is looking slightly to his left. Behind him are several computer monitors displaying data, and a large window showing a city skyline with the letters 'NY' visible. The room is filled with technical equipment and cables.

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To Grasso's detractors, what matters most is not financial results

improper practices on the NYSE trading floor. Criticism was mounting over the NYSE's lack of transparency and unique version of governance, under which Citigroup Chairman Sanford I. Weill, then under regulatory scrutiny, was offered a seat on the NYSE board of directors—not in his role as a financier but as a representative of the “public.”

Cover Story

As a “private entity with a public purpose,” to use a phrase often employed by Grasso, the stock exchange is expected to take the high moral ground—to set standards. Since becoming chairman in 1994, Grasso has firmly staked out that ground and parlayed that into unparalleled financial success. “He has waved the flag often enough to persuade investors and the world and public opinion that the NYSE is an American icon,” observes former SEC Chairman Arthur Levitt.

Somehow, the high ground has slipped away. How did it happen? Interviews with NYSE insiders, the exchange's competitors, critics, and allies—and Grasso himself—paint a picture of a complex institution that is superbly managed as a private enterprise yet is, as its critics contend, a parody of corporate governance. Far from serving as the gold standard for Corporate America, Grasso instead presides over an institution that has only grudgingly and belatedly engaged in reform of its internal governance—despite its public responsibility as a regulatory body.

Grasso's NYSE has an uneven record as a regulator, nabbing insider traders with admirable alacrity but often criticized for not adequately regulating the behavior of its floor traders and member firms—such as the specialists who manage trading of NYSE stocks. To be listed on the NYSE, companies must meet certain standards of governance, giving the exchange a voice in the national dialogue over corporate reform.

At a time when public policy is tilting toward stronger, more independent boards, the NYSE's board of directors falls short. The board—which includes such non-Wall Street luminaries as Avon Products CEO Andrea Jung, Viacom President Mel Karmazin, and former Secretary of State Madeleine K. Albright—is virtually handpicked by Grasso, who essentially

determines the board's composition despite a supposedly “independent” nomination process. Indeed, Grasso's assertion that the board member-selection process is independent—even more independent than that of most public corporations—have been so vociferous that he appears to have provided incomplete or even misleading testimony on that score to the Senate Banking Committee in May.

So what did Grasso do to earn his \$140 million? Simply he took good care of his primary constituency—the men and women who own memberships, or “seats,” that enable them to trade on the NYSE floor. Even though seat holders say they were stunned when they learned his pay package, most appear to have accepted it with equanimity. Robert W. Seijas, ex-CEO of Merrill Lynch Special



A STEADY HAND

On Friday morning, Aug. 15, Grasso assured traders that the power failure would not affect operations

and an exchange veteran, says the reason is simple: “The holders are the [NYSE's] shareholders, and they've seen an extraordinary increase in the value of their shares.”

That's because Grasso is an undeniably talented manager. Early in his tenure as chairman, he made the NYSE powerhouse for initial public offerings, grabbing business that once belonged to NASDAQ. Even his sharpest critics agree that Grasso's has almost single-handedly built the exchange's public image—which, along with an intense market-oriented approach, has helped maintain the NYSE's market-share numbers. In 1999, seat prices reached a time high of \$2.6 million. Even today, despite a three-year bear market, exchange seats are selling for \$2 million—the same as they were during the tail end of the bull market in 2000. By contrast, seat prices were as low as \$760,000 when Grasso took over the NYSE in 1994.

investments outside of the NYSE—and fewer stocks of companies—can boast such impressive results. For NYSE board compensation committee chairman Kenneth Grasso, who owns two NYSE seats, notes that he leases most of his seats—and that, with annual lease prices in the \$100,000 range, the rate of return from the leases is a 10% or better, even for seats that were purchased at the height of the market. Indeed, for longtime NYSE members in the 1970s, seats could be bought for as little as \$100,000—owning an exchange seat is a real gold mine. With seat sale and lease prices so healthy, the exchange's public-relations campaign under Grasso generated controversy even though it irritated some traditionalists who disliked Grasso's PR stunts. Grasso's leadership on Sep-

Grasso's hardscrabble early life has, if anything, burnished his reputation on the trading floor—a blue-collar stronghold where college degrees are strictly optional. Grasso's father left the family when Richard was an infant, and he was raised in a working-class neighborhood in Queens, N. Y., by his mother and two unmarried aunts. Young Grasso, like many traders at the exchange, was a "street kid." An indifferent student at Newtown High School, he dropped out of New York's Pace University and subsequently served two years in the U.S. Army in the 1960s. It is the stuff of internal folklore how he landed a clerk's job in the NYSE's stock lists department two weeks after leaving the army in 1968, adapted rapidly to the NYSE's arcane procedures, and quickly became a rising star.

Grasso made friends easily and became a favorite of the floor community. In the early '80s, he even had a chance to become a specialist, in the employ of his good friend, veteran specialist William Johnston. But Grasso turned down the job because of an even more promising alliance with the man who became his mentor and patron—and, in later life, his neighbor in Long Island's fashionable Locust Valley. The taciturn ex-Marine and second-generation specialist John J. Phelan Jr. became president of the Big Board in 1980 and then chairman, and Grasso rose along with him. In 1988, Grasso became president of the exchange.

Phelan's successor was Donaldson, educated at Yale University and a founder of the brokerage firm Donaldson, Lufkin & Jenrette. In an ironic twist—given Grasso's recent conflict with Donaldson—Grasso owes his career to the current SEC chairman. The working relationship forged between these two very different men was a tribute to the political savvy and the pragmatism of both. Grasso had considered resigning when Donaldson got the appointment in

1991 but stayed on after meeting Donaldson for a leisurely dinner at a Manhattan restaurant. Donaldson offered Grasso what the latter describes as a "partnership." Grasso accepted.

As managers, the two men were polar opposites—Donaldson detached and aloof, a delegator. "Bill Donaldson brought a more professional, CEO-kind of management," says Catherine R. Kinney, now co-president of the NYSE and executive vice-chairman of the board of directors. "Bill delegated to

HALF FULL OR HALF EMPTY?

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WHILE HIS CRITICS FAULT HIM FOR:

- Taking home a \$140 million pay package that has become a huge source of embarrassment
- Failing to reform the NYSE's internal governance
- Neglecting large institutions, which complain of poor treatment and bad pricing
- Showing poor judgment by serving on the boards of both Home Depot and Computer Associates

Data: BusinessWeek



er 11—when the exchange swiftly resumed trading dealt a severe damage to Lower Manhattan—cemented his reputation for crisis management, as did his performance during the recent blackout. Unfortunately for Grasso, September 11 was followed by a wave of corporate scandals that focused attention on the NYSE's weak spot—its corporate governance.

"Corporate governance" at the NYSE were to be judged solely on the basis of its CEO's relationship with his shareholders, Grasso could hardly be better. Grasso has a special relationship on the floor: He meets with seat holders often, in sometimes raucous informal gatherings and also in one-on-one meetings. It's no difficult feat, considering the manageable number of seat holders and the fact that most of them work in his neighborhood. They are not just his corporate overlords and ultimate bosses. They are his friends—in a sense, his family.

NOT AMUSED

Bill Donaldson, the SEC chairman asking tough questions, was Grasso's predecessor at the NYSE

Dick. He was the advocate, the visionary, the outside person, and Dick was very much the chief operating officer and ran the exchange," says Kinney.

The two men differed in ways that had important internal symbolism. Grasso came to the trading floor almost every day, glad-handing and slapping backs, and almost never missed a retirement dinner—whereas Donaldson rarely could be seen at such occasions. It's not just "shareholder relations," say

friends. Grasso genuinely enjoys these events, posing eagerly for photographs with

retirees as eagerly as he appears in daily photo opportunities during the ritual ringing of the opening bell.

Grasso brought the same hands-on approach to the NYSE's external relationships, at the same time as he intensely focused on the nitty-gritty of market share and competition for listings. He raised the exchange's public image, gaining free publicity by persuading celebrities to ring the opening bell—and engaging in publicity stunts such as a charity boxing match and appearing in an episode of the HBO series *Sex and the City*.

Grasso also mended Donaldson's uneasy relationship with Arthur Levitt's SEC. Indeed, the difference in the two men's approach to the SEC is instructive, particularly in light of recent events. As NYSE chairman, Donaldson had wanted to encourage overseas companies to list on the exchange by pressing the SEC to relax rules requiring the application of generally accepted accounting principles (GAAP) to non-U.S. companies. Levitt refused, straining relations with the NYSE. But instead of irritating Levitt and the SEC by pushing that losing cause, Grasso and Levitt agreed that the SEC chairman, a former chairman of the American Stock Exchange, would join him in a campaign to attract overseas companies. Levitt said the deal was that "the two of us will go around the world attracting listings." After all, he told Grasso, "I'm a pretty good listings salesman." Grasso agreed, avoiding a nasty political battle.

Grasso's hands-on approach to the exchange's management extends to its highest echelons. The NYSE board of directors, unlike most corporate boards, does not nominate its own members. Theoretically, that

makes it more independent than corporate boards—Grasso has repeatedly emphasized in his public statements and in his appearance before the Senate Banking Committee on May 7, in which he was questioned sharply by Paul Sarbanes (D-Md.) on his role in the Weill affair. Grasso has explained time and again that the exchange has a nominating committee, independent of the board, that its members of the board. Nominating committee members, a mix of financial and public representatives, are not all serve on the board. The current committee includes prominent members as Prudential Financial President F. Ryan and New York University President John D. Dolan. The committee has a long history, dating back to the 1970s, and in theory it should insulate the board from

STAYING THE SAME

The "specialist" system on the floor of the NYSE is one thing insiders say won't change

so and provide a good independent source of members, who serve for long terms.

In practice, it's not quite work that way. Grasso, a man of academic interest, was in the wake of the Weill fiasco, the selection of Hong Kong guru Martha Stewart to the board not long after her recent travails. Though the nominating committee picked Weill, Grasso concedes that the idea of selecting him—and a board member, for that matter—was actually his interview with *BusinessWeek*, which took place prior to recent problems. Grasso explains that he has an "annual audience" with the nominating committee, in which he provides names of potential board members from the nominating committee makes its selections.

The nominating committee is not obliged to follow Grasso's choices, but it usually does so. "We have a dialogue every spring," Grasso told *BusinessWeek*. "I usually put out five to seven candidates. And they're usually compelled to listen to five to seven. They do whatever they want. In contrast, Grasso's Banking Committee has emphasized the independence of the process. Grasso testified that "there is no ration of the chief executive from that nominating committee." An NYSE spokesman, Ray Pellechia, denies Grasso was misleading.



HOW GRASSO SERVES HIS SHAREHOLDERS

As chairman of the New York Stock Exchange, Richard A. Grasso reports to a Board of Directors—but his ultimate bosses are the 1,366 seat holders. Here is why they like Grasso:

■ Seat prices have tripled in price since he became chairman in 1994, rising to \$2 million apiece despite the bear market. Seats can be leased annually at \$200,000 or more—a return on investment of at least 10%.

■ Grasso has invested \$2 billion in upgrading technology and trading but has kept the exchange's controversial system of floor brokers and specialists intact.

■ Grasso is accessible to members, meets often with them, and listens to their complaints. He has known some members for decades and is simpatico to their concerns.

Data: *BusinessWeek*

Questions are everywhere. Insight is not.

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Grasso is mum on the subject of his pay, saying he had no input

testimony and says that time constraints prevented a fuller explanation. He also pointed to an Apr. 3 press briefing in which Grasso briefly mentioned, without elaboration, that he has an "audience" with the nominating committee.

Although CEO "audiences" with the nominating committee long predate Grasso, the practice—and the committee's failure to make independent choices—ensure that the board is not exactly a hotbed of dissent. Or, as board member William B.

Summers Jr. puts it, "people have great collective respect for one another." Indeed,

Cover Story

the NYSE board appears to be almost entirely free of strife and factionalism—and according to Langone, the board's votes on compensation issues have been unanimous for years. Langone, a former chairman of Home Depot, served as head of the human resources and compensation committee from 1998 until June, 2003. He is a close friend of Grasso, so close in fact that Grasso served on the Home Depot Inc. board until adverse publicity caused him to resign. Langone left the NYSE's compensation committee as a result of the controversy. Grasso's earlier term on the board of Computer Associates International Inc. had also drawn fire, in part because of that company's lavish executive compensation.

Blessed with such a harmonious board, filled with friends such as Langone, it was little wonder that Grasso wound up with a sweet pay package when his contract was last negotiated in 1999. The compensation committee, based on recommendations from the consulting firm Hewitt Associates, used as benchmarks the pay of financial-services executives. Grasso was given the option, which he exercised, of deferring his pay and bonuses at a risk-free rate of 8% a year—although Summers and Langone say they do not know whether that interest was yielded by an investment contract with an independent investment manager, or was simply paid by the NYSE.

According to Summers, the pay package that was provided to Grasso in 1999—and its controversial interest rate for accrued pay—reflected the soaring prospects of the exchange and the fact that Grasso was not eligible to receive the stock options that were all the rage at the time. There was, he maintained, no sentiment for pegging Grasso's salary to the pay scale of regulators. That would have cut his pay—which includes but is not limited to a base salary of \$1.4 million and an annual bonus of \$1 million—to just a fraction of its current level. (Donaldson, by contrast, earns about \$140,000 a year at the SEC.)

Summers could shed no light on the combination of previous bonuses that led to Grasso's \$140 million accumulation, which he will receive in a deal that extends his contract expiration from 2005 to 2007. "It was put in place at a time when 8% did not raise eyebrows," says another person familiar with the board's decision. The exchange has declined to elaborate on the composition of the package—or how much Grasso was paid each year—beyond saying in a statement that \$40 million was from "his savings account balance." The other \$51.6 million consisted of a "previously accrued retirement benefit," and another \$47.9 million were "retention or incentive awards."

The decision to extend Grasso's contract through 2007, though only recently announced—actually took place in 2002, according to a person familiar with the chain of command. Harvey Pitt was leaving as head of the SEC, Paul H. Volcker was departing as Treasury Secretary, and Grasso was named as a possible successor to both of them. That led to the compensation committee—then under Grasso's pal Langone—to send a member to approach Grasso to discuss a possible

extension of the contract. Grasso was agreeable to extension of his contract—but only for two years. Thus Grasso's decision to stay at the stock exchange was announced long before the contract extension was announced. People familiar with the decision vigorously deny that Grasso cashed out his deferred compensation—thereby triggering his 8% interest bonanza—because of the potential for adverse publicity. But if that were the case, it backfired, judging from the vociferous reaction.

Grasso himself has long been mum on the subject of his compensation, saying that he has no input into his pay and that the words he has given the board on the subject are "thank you." He is likewise serene on the other button subjects concerning his tenure, including the age-old question over whether the NYSE provides better service to his customers than the competition. His compensation business models are, he says, "compelling." His deadpan explanation of the hardly changes, not even in the second hour of a three-hour interview with *BusinessWeek*, but his words are laced with sarcasm. "I guess they should feel pretty good about that," he says. "That means they think they're going to get us out of business."

Grasso has seen to it that after he is gone, change at the NYSE is likely to be incremental at best—with the interests of his shareholders remaining a matter of minor importance. Eliminating the exchange's floor-trading system, as urged by some exchange

FINANCIAL EXECS DOMINATE THE NYSE BOARD

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ROBERT G. BRITZ, Executive Vice-Chairman
CATHERINE R. KINNEY, Executive Vice-Chairman

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JAMES M. DURYEA J.M. Duryea
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HENRY M. PAULSON JR. Goldman Sachs
PHILIP J. PURCELL Morgan Stanley
CHRISTOPHER C. QUICK Fleet Specialist
WILLIAM B. SUMMERS JR. McDonald Investments

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CAROL BARTZ Autodesk
ANDREA JUNG Avon Products
MEL KARMAZIN Viacom
PETER N. LARSON Brunswick (retired)
GERALD M. LEVIN AOL Time Warner (retired)
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Data: New York Stock Exchange

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Grasso's attitude toward competing exchanges: Bring 'em on

would be the equivalent of burning the wallets of those 1,366 members—and it is not about to happen. The specialists are the exchange, and the exchange is Grasso. "Some people say: 'The exchange will die in 100 years. Kill yourself tomorrow.' Forgive me if I don't elect that strategy," he says.

Specialists and floor brokers are likely to continue to hold sway at the exchange, for the simple reason that they own it and dominate its corporate

Cover Story

culture. When Grasso became chairman and CEO, he appointed his specialist friend and would-be employer Johnston as president. After Johnston's retirement at the beginning of 2002, Grasso elevated two longtime insiders whose careers, like his own, had been spent entirely at the exchange: Kinney and Robert Britz both hold the title of president—exchange officials eschew the term "co-presidents"—

Bush on the subject of Iraqi guerrillas—"Bring 'em learn from them," he says of his competitors. "I think very good at adapting technology." But Grasso is more just an apt pupil. His attitude toward competitors is a combination of bemusement and condescension. Asked about upstart named Liquidnet, a computer system that joins trading desks of institutional investors electronically, is suitably restrained. "What are they doing? About 100 shares a day?" asks Grasso. "If they're good, they'll die of liquidity. What draws liquidity is better pricing." If you believe they can get better prices elsewhere, he says, they should go elsewhere.

Many institutional investors contend that Grasso is a Traders, they maintain, flock to markets where they can most easily find a buyer or seller—even when pricing is the fairest. And indeed, they charge that at the NYSE block trades get worse prices than smaller ones. Says one vocal Grasso critic whose Lek Securities has 15 seats

on the exchange floor, says the No. 1 exchange "won't give you the right—being smart—to antagonize customers and say: 'I'm not so good, don't trade here.' Because that's what it takes to become a self-fulfilling prophecy."

Only Bill Donaldson can make such prophecies come to reality. Dick Grasso's challenge to deal successfully with Donaldson's SEC is likely to be the biggest test of his career. Grasso could go a long way toward defusing this crisis by redefining the composition of the compensation committee to ensure that no executive of the company regulated by the SEC can have a say in his own check. He could also consider giving back some of the money.

Grasso has managed to charm his way out of difficulties before, dating back to the days when he was a fatherless boy in

CLIMBING THE BIG BOARD



1981: Grasso at the age of 35

- Born in Queens, N.Y., in 1946
- Graduated from Newtown High School, 1964
- U.S. Army, 1966-68
- Joined NYSE as clerk in the stock lists department, 1968
- Director of listings and marketing, 1973
- Vice-president for corporate services, 1977
- Senior vice-president for corporate services, 1981
- Executive vice-president for the marketing group, 1983
- Executive vice-president for capital markets, 1986
- President and chief operating officer, 1988
- Executive vice-chairman, 1991
- Chairman and chief executive officer, 1995

Data: New York Stock Exchange



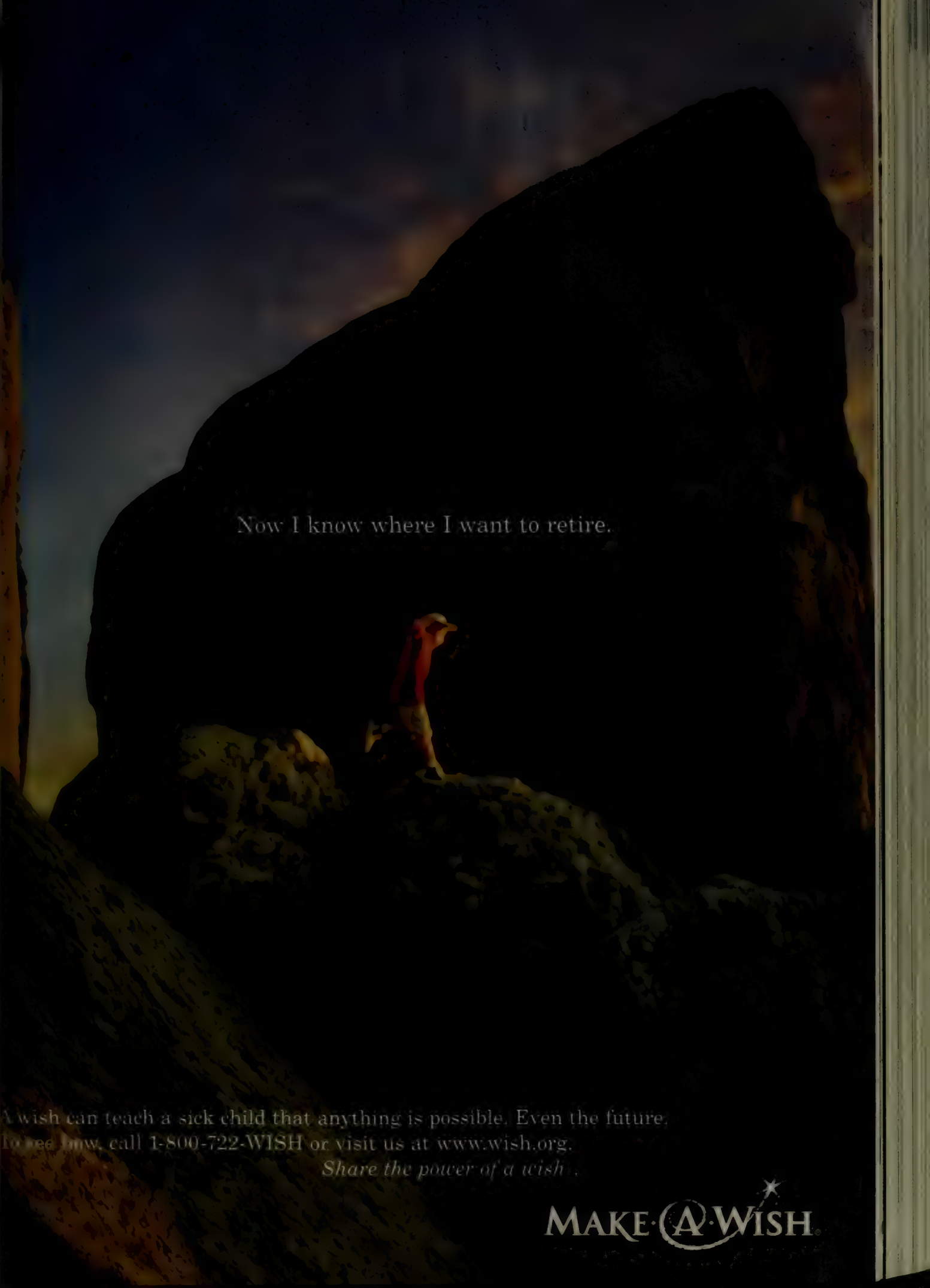
EASY RIDER: Grasso has charmed his way out of many a tight spot before

and their experiences and temperaments dovetail as neatly as Donaldson's and Grasso's. The outgoing Kinney, who began as a regulatory trainee in 1974 and moved into marketing under Grasso's tutelage, is the "Ms. Outside." The more taciturn Britz, a 30-year exchange veteran who began in the Grasso manner as a listings rep, is the "Mr. Inside." The two complement each other while not, as it happens, posing anything resembling a threat to Grasso.

When it comes to threats, Grasso is an old and seasoned warrior. Internal threats? Not very likely, with Grasso effectively controlling the board. Competitive threats? Asked about them, Grasso's reaction is reminiscent of George W.

Traders are avid gamblers, and—while there are small odds on the subject—the betting on the trading that in a one-on-one match, Grasso vs. Donaldson, who went to Yale loses to the guy who went to NYU. High. Period.

That would be a smart wager if not for one thing: The public's patience with the NYSE is growing short. For Dick Grasso has been the undisputed overlord of a priority that all too often has paid lip service to its public. It's a long-running act. But an experienced showman Grasso ought to know better than anyone when a long-running act is starting to wear thin.

A child is seen from behind, climbing a large, dark rock. The child is wearing a red shirt and light-colored shorts. The scene is set against a dramatic sky with orange and yellow hues, suggesting sunset or sunrise. The rock is massive and craggy, with the child appearing small in comparison.

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POISED TO POUNCE:

Leonard is set to invade Delta's most profitable routes

closely enough at the ugly reality of what it was.

Now, it seems as if that was for the best. Starting with those first sleepless 48 hours as he combed the finances looking for ways to raise cash, Leonard has outsmarted rivals, outlasted the ValuJet stigma, and turned AirTran into the second-largest discounter, after Southwest Airlines Co. AirTran earned \$11 million in 2002, one of only three profitable carriers last year, and ended the second quarter with \$343 million in cash. In contrast, Delta Air Lines Inc., AirTran's main rival, lost \$1.3 billion last year. Although AirTran offers less than one-tenth as many flights, its market cap is \$1 billion, vs. \$1.7 billion for Delta. "Leonard has built one of sharpest and most aggressive management teams in airlines," says Stuart A. Klaskin, a Coral Gables, Fla., airline consultant.

Today, Leonard is homing in even closer on Delta. No longer will he just cherry-pick underserved East Coast destinations such as Baltimore. In the next five years, he plans to double the number of AirTran flights, invading Delta's most profitable routes, including Los Angeles and cities in Mexico and the Caribbean. He is ordering up to 100 fuel-efficient 737s from Boeing Co., which will enable AirTran to fly cross-country for the first time. "We can put airplanes anywhere we want, and there's nothing Delta can do about it because our cost structure is so much lower," he says.

While there's a bit of catch-me-if-you-can swagger to Leonard these days, success on his own terms has been a long time coming. As the enforcer for Northwest Airlines Corp.'s former CEO Donald W. Nyrop and Eastern Air Lines' Frank Borman, he has laid off thousands, battled angry union workers, and often been more feared than loved. "Joe always had to do the dirty work, take the hit for others," says J. Randolph Babbitt, an airline consultant and former Eastern pilot.

But if anyone has jet fuel coursing

EXECUTIVE SUITE

CATCH HIM IF YOU CAN

Leonard's low costs have AirTran outflying Delta

Robert B. Leonard almost broke down in tears on his first day as CEO of AirTran Holdings Inc., in May, 1999. At a 6:30 a.m. meeting, he learned the low-cost carrier's cash had dwindled to \$10 million, enough to stay aloft only a few weeks. "If I'd done a proper job of due diligence, I should have never taken the job," says Leonard.

He made a strange admission from a man who has worked in the industry for near-

ly four decades, seen one employer (Eastern) go bankrupt, and helped save another (Northwest) from the same fate. It's especially odd since AirTran had been pretty much written off in 1996: Back then, it was known as ValuJet Airlines Inc., the airline whose poor maintenance was blamed for a crash in the Florida Everglades, killing all 110 on board. Leonard probably should have known better. But he was so excited about what AirTran could be that he didn't look

People

through his veins, it's Leonard. He grew up next door to the airport in Augusta, Ga., in the years after World War II. By age 11, he was pumping gas in exchange for flying lessons. And by 1967, he had graduated from Auburn University with a degree in aerospace engineering. His first job out of college was evaluating planes at Boeing. To this day, says Lawrence A. Bossidy, retired chairman and CEO of Honeywell International Inc. and a former boss, "Joe would rather check out a nearby aircraft plant than play golf."

After two years at Boeing, Leonard settled into Northwest, where he became a protégé of the flinty Nyrop, who demanded that any expenditure over \$19.95 get his personal approval. The art of cost-cutting proved invaluable in his next assignment as senior vice-president of maintenance—and later, CEO—at Eastern. Borman, a former astronaut, had kept the struggling airline in business through sheer willpower. But the regal Borman didn't mingle with employees, and his unions were growing increasingly militant as Eastern asked for ever more wage and work-rule concessions. Borman assigned Leonard the task of winning those concessions from union leaders while keeping the peace.

It was an impossible mission. Eastern collapsed in 1991, and Leonard returned to Northwest, which was itself struggling to stay out of bankruptcy. CEO John H. Dasburg credited Leonard with keeping the airline flying. "He's the quintessential operations guy," says Dasburg. "He could have succeeded me." Leonard, though, had other ideas. Burnt out by the industry's bitter labor struggles, he left Northwest in 1993 for aerospace conglomerate AlliedSignal. AlliedSignal's Bossidy put him in charge of turning around the troubled Honeywell acquisition. "He took out a lot of people without flinching," says Bossidy.

While Leonard may have thought he was done with airlines, the industry wasn't done with him. In 1994, soon after he joined AlliedSignal, personal friend Lewis H. Jordan approached him about running his new Atlanta-based discount carrier, ValuJet. Leonard rebuffed Jordan, who remains an AirTran director, until 1999. By then, the company was in desperate straits. After the 1996 crash, it had merged with Orlando-based AirTran and adopted its name, but it was poorly run, heavily in debt,



and nowhere near making a profit. Leonard thought he saw a way out. AirTran had acquired Eastern's 18 gates at busy Hartsfield Atlanta International Airport. Delta, of course, also called Hartsfield home. The airline then was one of the world's most successful, but as a native Southerner, Leonard knew a dirty secret: Delta's customers, especially business travelers, had become increasingly disillusioned with mediocre service and high prices.

Leonard gambled on a strategy unlike any other that discounters had tried. They went after the leisure

crowd; he would go after the traveler. They flew directly cities he would operate AirTran on a system that major airlines used. Business fliers got the same amenities as roomy seats, available on, say, but at fares up to 60% higher. Leonard also let coach customers upgrade to first class at the gate (now \$30). "Who doesn't have it in his pocket?" he says.

To make a go of it, Leonard went to the bone. Pilots help load and senior pilots earn about \$100 less on average than those at Delta. Leonard turns off the air conditioning when he goes home at night. Savings helped lower AirTran's cost per available passenger mile to 11¢ at Delta. To keep up, Leonard invites competitors to find him very willing to negotiate. "We have a disagreement," he says. "We have a disagreement." AirTran pilot union leader Patrick Sean Sullivan.

Delta isn't sitting idly on the tarmac. It has matched AirTran's fares, has more than 100 of its routes, and is planning to cut costs by some \$500 million in the next two years. That means Delta is becoming another AirTran, says Delta President Richard W. Reid: "We think we deserve a premium in fares, since we have global reach." Leonard hopes Delta does keep that premium, but he's too worried one way or another that he believes that he could win the war, since his costs are so much lower than Delta's. As they say in the South, Leonard is just going to keep it where it hurts.

By Charles Haddad in Orlando

DIRE STRAITS When Leonard joined AirTran, it was heavily in debt and had just enough cash to stay aloft a few weeks.

AIRTRAN'S PREDECESSOR AIRLINE, VALUJET, WAS PRETTY MUCH WRITTEN OFF AFTER A 1996 CRASH.

JOSEPH LEONARD

BORN July 10, 1943 in Augusta, Ga.

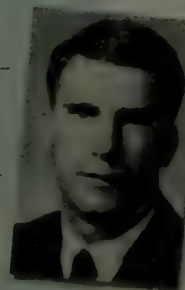
EDUCATION Aerospace engineering degree, Auburn University, 1967.

POSITION CEO of AirTran (once called ValuJet), the airline he raised from the swamps after a 1996 crash in Florida and transformed into a serious and profitable rival to Delta.

BONA FIDES Worked in the airline industry for four decades at Northwest, American, and Eastern—before joining AirTran in 1999.

AFTER HOURS Races cars in California to relax; otherwise drives a Porsche 911.

FAMILY Married to Phyllis; daughter, Maureen, is an AirTran pilot; son, Kevin, is in computer forensics.



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SEPTEMBER 15, 2003

Virtual Help for Your Real Life

Assistants You
Never See
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Dividends

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TODDI GUTNER

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GA FOR HFLIERS

Crowded airports and cramped airplane seats make air travel anything but relaxing. To

eviate the stress, *Yoga* (Riverhead \$13) illustrates 35 yoga exercises to do in security lines, in flight, or baggage claim. Here are some examples:

TWIST AND NECK

Lean your elbow on the back of your head and put your chin in your hand. Lean your head to your right so your shoulder is to the left. Take five deep breaths.

BELLY TONER:

Sit up straight in chair with feet on floor. Inhale and lift both feet a few

inches off the floor without using your hands and draw the inside of your legs and feet toward your chest. Exhale to release tension back to the floor.

EMERGENCY DOOR LEAN:

Stand with feet under hips, arms pointed straight ahead. Inhale, and fully extend arms overhead. Lower left arm, exhale, and lean to your left. Don't allow your back to overarch. Inhale back to center.



INSURANCE

College Coverage

IF YOUR KIDS are heading off to college, especially for the first time, you probably need to **fine-tune your insurance coverage**. Your auto premiums should drop if your child doesn't take a family car to school, assuming the college is more than 100 miles away. For students with cars on campus, notify your insurer of the new location. If it's out of state, make sure you comply with that state's laws for minimum coverage. If your child has at least a B average, ask for a good-student discount.

For a child living in a dorm, your homeowner's policy may cover personal belongings up to 10% of your own contents coverage. If you need more, you can purchase a rider. Students in off-campus housing will need renter's insurance for property and liability. **Roommates often can share a policy.**

Your health insurance covers unmarried children who are full-time students up to age 20 to 25, depending on the insurer. If you're in an HMO, make sure the college is within your service area. When your children reach the age limit, or get married, they qualify for COBRA coverage through your employer.

Larry Armstrong

GADGETS

HANDY HANGER



It's the best-looking hardware for hanging any gadget from your belt, body, or bag. **Rivet from Roadwired.com** is a system of aluminum and stainless-steel fasteners for handheld computers, phones, and cameras. The starter set, with a belt clip, is \$30; the \$40 "Power Broker" lets you hang items from your neck and dashboard.

STOCKS

IPOs: SIGNS OF LIFE

Could the IPO market be coming back? Yes, when you consider that IPO filings in August hit levels not seen since May, 2002.

	2002	2003
JANUARY	10	5
FEBRUARY	14	1
MARCH	21	1
APRIL	25	3
MAY	19	6
JUNE	12	4
JULY	8	8
AUGUST	10	20
SEPTEMBER	4	n/a
OCTOBER	3	n/a
NOVEMBER	2	n/a
DECEMBER	6	n/a

N/A: Data not available

Data: Renaissance Capital Holdings Ltd.

Office Help From Afar

More business owners are hiring virtual assistants to handle tasks from bookkeeping to buying gifts for Mom. **BY ELLEN HOFFMAN**



VAL WILLIAMS' executive-coaching business grew so fast when she started it four years ago that she quickly fell behind in billing. She got rid of the backlog by getting help from someone she still works with but has never met in person—a virtual assistant (VA) who lives in Michigan and communicates with Williams' Edison (N.J.) office by e-mail, fax, and telephone. The VA, referred to Williams by a business associate, took over “invoicing, collections, personal errands such as sending flowers to my mother, and getting train tickets,” Williams says. As a result, she is “now free to do the activities that only I can do—coaching, delivering a seminar, or marketing.”

Williams is one of thousands of business owners who are turning over administrative tasks to virtual assistants. These helpers are self-employed, home-based workers—usually

women—who do anything from processing and bookkeeping to research and meeting-planning for clients who live far away or frequently.

Using a remote helper has a number of advantages over having someone working down the hall. “I can hire someone who’s extremely professional but I don’t have all the expense [of health insurance and maintaining office space] associated with a full-time assistant,” says Miguel Berger, president of TechValley Homes Real Estate in Loudonville, N.Y. Berger, who often, uses time in the air to work lists he can e-mail to two assistants—one in Albany, who handles his accounting, and one in Durham, Ky., who designs marketing materials. He’s looking for a third VA to manage his database.

VAs charge anywhere from \$25 an hour, depending on their skill level and the complexity of the tasks they handle. Most give clients the option of paying a monthly retainer or an hourly rate.



sulting firm in Del Mar, Calif., says she was overworked and gave up vacations for years because she didn't want to hire someone to work in her home or move the business to a separate office. She learned about VAs at a women's networking meeting in 1999 and soon hired Christine Barnes in San Diego to take on jobs such as responding to voicemail, sorting e-mail, and maintaining a newsletter mailing list of 1,600 names. Barnes is so much a part of Duester's business that at noon and 5 p.m. every day, she sends Duester an electronic to-do list. Now that she has help, Duester says she takes quarterly vacations, many to accompany her microbiologist husband to international meetings.

VAs come from a wide range of backgrounds. Angela Allen, president of International Virtual Assistants Assn. (IVAA) and one of Berger's VAs, worked in marketing, advertising, journalism, and human resources. Jill Chongva of Berwick, N.S., was a medical secretary and also

worked in a camera shop, and Janet Winter of Cumming, Ga., had been a math teacher, school financial-aid director, and a travel agent. "A VA should be able to handle anything for you," says Brice. "If you need to buy a condo in Hong Kong, she should be able to figure out how to help you to do it." Among the assignments that Winter has completed for clients, she says, was creating an inventory system for an aromatherapist who bought fragrant essential oils in

hires these folks? Typically, in the coaching industry, writers, authors, real estate professionals, and consultants—especially people who are working solo from home," says Brice, the Cockeysville (Md.) president of AssistU, an organization that offers training courses for virtual assistants. Often, clients' businesses are growing faster than they can handle alone.

Duester, who owns a food-con-

PS FOR WORKING TH A VIRTUAL ASSISTANT

AVOID misunderstandings by being clear about your expectations at the beginning of the relationship and for each project.

REALIZE that a virtual assistant, unlike the office secretary you see every day, is a business owner whose perspective is that of a partner rather than an employee.

DON'T MICROMANAGE your VA. You're paying for someone who doesn't need a lot of supervision.

DON'T EXPECT your VA to directly generate cash. VAs are not salespeople.

Referral Lists

AssistU assistu.com

More than 500 people have taken its 20-week training course

International Virtual Assistants Assn.

ivaa.org

Has 600 members, some are certified

Staffcentrix staffcentrix.com

Training and referral agency for military spouses who are VAs

large bottles but sold them by the drop.

To find a VA, you can start with an Internet search for "virtual assistant," which will turn up Web sites of individuals and organizations. There's no universal certification, though credentials from a VA group that trains or certifies members offer some assurance that the person has passed an ethics or skills test.

PERFORMANCE EVALUATIONS

Exams sponsored by the IVAA (table, above) lead to three types of certification: one in business ethics (\$25 for members, \$50 for nonmembers), one on skills and issues related to real estate (\$25 or \$50), and one for members only based on proficiency in word processing, spreadsheets, and other administrative skills (\$100). Brice's AssistU offers a Certified Professional Virtual Assistant (CPVA) and Certified Master Virtual Assistant (CMVA). To become a CPVA, a student must complete 20 weeks of classes by conference call and pass an exam based on performance in simulated experiences with clients (\$2,295 for group classes; \$3,195 for a one-on-one trainer). The CMVA designation, for an additional \$250, requires proof of 1,500 hours of work as a VA and documentation that clients find the assistant's work to be effective.

Staffcentrix, which functions as a referral agency for military spouses who are VAs, doesn't test those on its list on specific skills. But it offers a free 15-hour training course on some military bases. That training focuses on customer service, ethics, and practical knowledge necessary to start and operate a business.

Even if you choose a VA who has completed some type of training or received certification from a trade group, before making a commitment, you should test out the relationship by working on a short-term project together (table, left). Even if you don't see the person in the office every day, you still have to know that your work styles are compatible. ■



Luxury—With No Strings

Vacation clubs offer you a range of quality resort homes at a fraction of the cost of owning. **BY PALLAVI GOGOI**

from \$150,000 to \$475,000, annual dues from \$8,000 to \$17,500. You can get a guaranteed stay of up to six weeks a year at club properties from Hawaii to

WHEN IT COMES TO vacation homes, Joel Liffmann, a hedge-fund partner from Greenwich, Conn., says he has tried them all. Liffmann has rented homes and condos but wasn't happy with the lack of maintenance. He bought a few weeks at a high-end Beaver Creek (Colo.)

time-share, but they didn't always match the kids' ever-changing vacation schedules. Still, he shied away from buying a vacation home because of the cost, responsibility, and commitment to one location. So when he heard about Private Retreats, a vacation club with a collection of upscale residences in several resort areas, it hit the spot. "It solved my vacation dilemma," says Liffmann.

The latest twist in the vacation home industry doesn't center on ownership, unlike the luxury time-shares Ritz-Carlton and Four Seasons started marketing three years ago. Working from a country club business model, these plans offer access to million-dollar-plus resort homes for an up-front membership fee that ranges

from Colorado to Mexico, but you can get more dependent on availability. Private Retreats currently has just three competitors: Exclusive Resorts, Mirabella Estates, and Odyssey Club (table).

Are these clubs worthwhile? It depends on how you use them. If you want to vacation for just two weeks a year, they're probably too expensive. But if you have more time to spend, have a large family to accommodate, or would like to invite other guests, the considerations change. *By Pallavi Gogoi*

The Vacation Club Universe

COMPANY	INITIATION FEE	AMOUNT REFUNDABLE	ANNUAL DUES	GUARANTEED WEEKS	HOMES AVAILABLE
Exclusive Resorts exclusiveresortsllc.com	\$150,000 to 250,000	80%	\$8,000-16,000	At least 2	29
Mirabella Estates mirabellaestates.com	375,000 to 475,000	100	15,000-17,500	At least 4	15
Odyssey Club* theodysseyclub.com	300,000	80	15,000	At least 2	25
Private Retreats private-retreats.com	250,000	100	8,750**	4	70

*opening Jan. 2004 **plus \$150 per night per home



Week looked for several upscale rentals in Colorado and Hawaii, posh homes with a minimum of four bedrooms. A two-week rental would run from \$15,000 to \$25,000—about the same as the annual dues at some of the vacation clubs.

JUST SHOW

UP: Clockwise from left: An Exclusive Resorts home in Los Cabos, Mexico, and from Private Retreats, Belize and Steamboat Springs, Colo.



But with a club, you get guaranteed access in peak seasons and quality assurance. If you're not satisfied, most clubs offer a full or 80% refund of the initiation fee. Another benefit is the service. The clubs' staff will take care of everything from rental cars and groceries to ski equipment rentals and restaurant reservations. So all you have to do is show up and kick back.

How do these clubs guarantee access when there are so many more members than properties? With the Dartmouth College mathematicians, Private Retreats b McGrath figured that if he capped the membership at 400 and had at least 70 homes in different locations, he would likely get what they wanted, and overbooked take place only about 4% of the time. On those rare occasions when demand exceeds supply, Private Retreats homes from other owners within the resort area.

McGrath also made sure his membership was geographically diverse. That way, families from Boston or New York want warm-weather vacations during the winter, but from Florida or Southern California would seek other. He also limited the pool of members with school-age children, so as not to overwhelm vacation destinations during holidays.

Private Retreats, which was the first in the market in 1999 with only 30 members, recently reached its maximum capacity of 400 and is planning to launch a second club, where homes will cost an average of \$2 million and the initiation fee will be \$450,000, as opposed to the current \$250,000. It attributes the success of the concept to the post-bubble emphasis on fiscal responsibility. "During the bubble, people would go out and buy one or two vacation homes, but what we have is a defensive investment where for a portion of the time they can enjoy the benefits of the second home," says Steve Gottlieb, Odyssey Club's CEO.

McGrath, who joined Private Retreats in February, 2002, looked back. "The desirable locations and having a lot of people who takes care of everything would be hard for me to do together at any cost," he says. As someone who has been in the industry for all, he's hooked on this concept. ■

TRAVEL

Time-share Yachting

Your dreams of owning a yacht may have just floated within reach. Arlington (Va.)-based **YachtSmart of North America** (fractionalyacht.com) is offering fractional ownership in two yachts that allows you to split the purchase and maintenance costs among 10 shareholders. Stockbrokers Jonathan Metcalfe and Philip Burroughs founded the company last year after Metcalfe tried vainly to purchase a 52-foot Fairline Squadron yacht but found the \$1 million investment and \$100,000 a year in maintenance and insurance prohibitive. Given the economic downturn, he knew he was not alone. "I don't know if our program would've gotten as much momentum in the late 1990s when people thought, 'Heck, I'll just buy the whole thing,'" says Metcalfe.

What's the cost? **A 62-foot Fairline Squadron is \$186,000 per share**, plus \$1,450 a month in maintenance. That allows you 28 days of boat time and includes a full-time captain and all upkeep of the boat. The yacht has three bedrooms, or "cabins" in boatspeak, with flat-screen satellite TVs and a Sony PlayStation for the kids. It also has a kitchen and dining room with cherry wood tables with eucalyptus inlays.

If you want to go more upscale, a share in an 85-foot Azimut yacht will run you \$425,000 a share plus \$2,600 in maintenance fees. This has four cabins with similar features.

Both cruise the Northeast in the summer, the Florida coast in the winter months. Fuel and dockage fees are not included. But if you can afford a share, who's going to quibble about that? *Lewis Braham*



THE FAIRLANE SQUADRON

FAIRLINE BOATS P/LC



bumps and boulders (and an incline steeper than the Hummer H2.)

It's also a luxury car, with the refinement of a Mercedes-Benz or BMW. At a price of \$35,515, or \$38,515 for the V-8 version, it's the most expensive car ever sold in the U.S.

HEAVY DUTY:

The Touareg weighs a lot but handles nicely

unlike its German competitors, the Touareg's base model is loaded with such standard features as dual-zone climate controls, a sunroof, heated seats, and rain-sensing wipers. The Touareg does not stint on safety equipment, either—with standard anti-lock brakes and skid control, air bags, and front side-impact air bags and side-impact protection bags to protect your head.

The interior is VW's best yet, with comfy leather seating for five (standard on the V-8, part of a \$2,200 premium upgrade).

The V-6) and an instrument cluster with jewel-like, chrome-rimmed gauges. Yes, that's real walnut and real aluminum trim. The one gaffe inside is the optional (\$2,350) navigation system. It's a primitive design that uses the in-dash audio player—so you have to choose between maps or music.

On the road, the car feels heavy, and it is. The Touareg tips the scales at more than 5,000 pounds. I thought it would put too much pressure on the accelerator to get it going from a dead stop—but once moving, it was surprisingly agile. Steering is more responsive than I expected from such a heavy vehicle, and it takes corners and curves with aplomb. None of that tippy feeling common to SUVs as tall as this. It's a smooth ride on highways, but things can get bumpy on bad city streets.

Where you pay for the weight, of course, is at the pump. The V-8 gets 14 miles per gallon in city driving and 18 on the highway, and the V-6 version is only a mile or two better. Worse, Volkswagen recommends using premium fuel.

About the name: It's pronounced tour-regg, and Volkswagen named it after a tribe of nomads in the Sahara called the Tuareg (pronounced twa-regg.) Whatever. VW's first SUV, with its upscale polish and its go-anywhere capability, is bound to set a higher standard in a field increasingly populated by crossover SUVs that get their muscle from souped-up styling alone.

One Tough SUV

VW's Touareg blends off-road chops and luxury. **BY LARRY ARMSTRONG**

LET'S JUST SAY I never expected a vehicle like this from Volkswagen, a brand better known for its quirky little Beetles and youthful Passats. But VW's Touareg sport-utility vehicle, which went on sale this summer, is no car-based crossover, no Passat wagon on steroids. It's a real SUV, with full-time four-wheel drive, designed to be driven off-road. There's even an optional suspension to raise it nearly 12 inches off the ground, enough clearance for the biggest

HOT CARS: Parts Crooks Love Best

The Cadillac Escalade sport-utility vehicle tops the insurance industry's list for both theft-claim frequency and loss per claim,



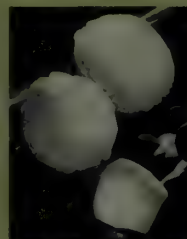
BLUE-WHITE HEADLIGHTS

says the Highway Loss Data Institute. But thieves usually steal cars to get easily removed, expensive parts. The industry doesn't keep statistics

on those, but here are some popular components that turn your car into a target:

LIGHTS. Those blue-white, high-intensity discharge headlights can really dazzle—especially when they're coming right at you. New ones go for \$500 and up per light, sometimes \$3,000 per car.

AIR BAGS. You gotta have 'em, but companies say that 10% of all theft



EASY-TO-STEAL AIR BAGS

claims involve an air bag. The driver's side bag, mounted in the steering wheel, is the easiest to remove and costs \$500 to \$1,000 to replace.

WHEELS. Custom rims are the easiest way to give your car a flashy new look, especially the "spinners" that keep revolving when the car is stopped. They go from \$100 each up to \$15,000 for a set of super-luxe models.



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Investing Without Blinders

Robert Arnott's funds look beyond stocks and bonds. **BY LEWIS BRAHAM**

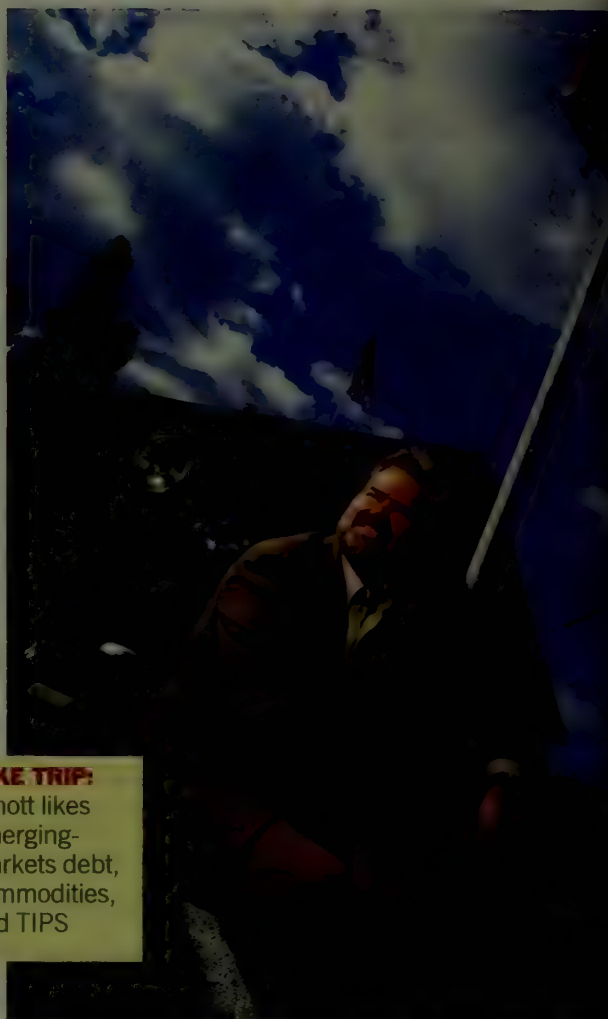
AT FIRST glance, Robert Arnott doesn't come across as a rebel. The 49-year-old portfolio manager of the PIMCO All Asset Fund is a by-the-numbers guy—a "quant" who wears dark suits, works 11-hour days, and edits the *Financial Analysts Journal* just for fun. But he has also been riding motorcycles à la James Dean since he was 16. "In a car, you're in this metal cocoon," he says. "On a motorcycle, there's a wonderful feeling of freedom, of being part of the world around you."

Arnott thinks most investors are also trapped in a cocoon, one that limits them to buying conventional stocks and bonds. Stocks, he argues, are still overpriced. "I believe that stock prices, adjusted for inflation, will be lower 15 years from now," he says. He also thinks yields on most government and corporate bonds are too skimpy. Instead, he invests in more unusual asset

classes, such as emerging-markets debt, commodities, and his current favorite, Treasury Inflation-Protected Securities (TIPS). And his fund, like his Brough Superior SS-100 motorcycle, is free to explore such obscure regions.

Arnott has an impressive track record. His Pasadena (Calif.) money management firm, First Quadrant, runs \$13 billion in private accounts for high-net-worth and institutional clients, including an account for a sovereign government, which he cannot disclose. All eight of First Quadrant's investment strategies have beaten their benchmarks since the firm's founding in 1985. The PIMCO fund is his first foray into mutual funds, and while it borrows from his firm's strategies, it is unique. Since its inception a year ago, the fund is up 18.5%.

Arnott's analysis of TIPS is unorthodox. These securities, issued by the U.S. Treasury, appreciate along with the inflation rate, plus they pay interest on top of that, historically ranging between 2% and 5%. Most published research on TIPS compares them with Treasury bonds. Arnott contends they are more akin to stocks. The reason is that the revenues and earnings of most companies are correlated with the inflation rate,



BIKE TRIP:

Arnott likes emerging-markets debt, commodities, and TIPS

growing when prices of goods and services rise and shrinking when they fall. And stock prices typically follow inflation's growth.

A CLASS BY ITSELF

Conventional Treasury bonds, on the other hand, are at the mercy of inflation. Because their rates are fixed, when inflation rises, Treasuries' "real" return above the inflation rate declines, while the real yield on stocks stays put. That, he argues, makes stocks a different asset class altogether, even compared with Treasury bonds. Long-term Treasury maturities of 25 years, now having a yield of 2.8%, while the average yield on long Treasury bonds has been 1.9% historically. Arnott thinks the "real" yield for TIPS is 1.5% because they are free of inflation risk. If he's right, TIPS should rally.

Relative to stocks, though, TIPS are spectacular. Currently, the dividend yield on the average stock in the Standard & Poor's 500-stock index is 1.7%—low end of its historical range. The average price-earnings ratio, based on stocks' current prices and trailing

Robert Arnott

TITLE: Chairman, First Quadrant, and Portfolio Manager, PIMCO All Asset Fund

RESIDENCE: Pasadena, Calif.

BORN: June 29, 1954

SCHOOL: University of California at Santa Barbara

DEGREE: B.S. in Economics, Applied Mathematics, and

Computer Science, University of California at Santa Barbara, 1977

KUDOS: Five Graham & Dodd Scroll awards, the Oscars of financial analysis

HOBBIES: Motorcycling and eclipse-chasing

GOAL: "We want our investors' real spending power to increase above inflation"



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year average earnings, is 28. And the "e" portion of that p-e ratio, Arnott contends, is overstated by as much as 40% because of the accounting shenanigans of the past decade. But what about more financial disclosure and expensing of options? That, he says, will make earnings in the future look even worse.

What's more, stocks have demographic trends working against them. "The first of the baby boomers start retiring in about five years," says Arnott. "Most likely, they will sell their riskiest assets first." Since stocks are more volatile than bonds and TIPS, they will be first to go.

Arnott will still ride a rally when he spots an opportunity. For instance, last October he had 20% of his portfolio in stocks as interest rates reached a point where stocks became more attractive than bonds. Lately, he has been selling stocks as rates have backed up: His weighting is just 7% now. Arnott doesn't pick stocks for the All Asset fund. In-

stead, it invests in the PIMCO StocksPLUS and PIMCO StocksPLUS Total Return funds. In fact, for all investments, Arnott employs other PIMCO mutual funds.

One of the more unusual asset classes Arnott uses is commodity-linked bonds. Only two other mutual funds, PIMCO Commodity Real Return Strategy and Oppenheimer Real Asset Fund, invest in these securities. Their returns are directly linked to the prices for such commodities as oil, natural gas, cattle, and corn. That makes them

better inflation hedges than the stocks of producers, which often react more to stock market moves than to commodity prices. Arnott's commodity weighting rose as high as 20% before the U.S.

war against Iraq, but it has since come down to 7%. He thinks the sector will take a breather until inflation begins to rise.

That's why 57% of All Asset fund's portfolio is invested in two PIMCO

funds. That has helped fund returns recently. But TIPS have fallen as Treasury bonds and interest rates backed up. "We have an administration pursuing a highly inflationary fiscal policy, and a Federal Reserve pursuing a highly inflationary monetary policy," Arnott says. Such conditions justify a sell-off of TIPS. "I'm glad

are people who believe TIPS are Treasuries," he says. "They create buying opportunities." Let them stay in their cocoon. Arnott's fund will rise when everybody else zags.

PIMCO ALL ASSET FUND

Symbol: PASDX
(For no-load D shares)

Expense ratio: 1.50%

Assets: \$462 million

Year-to-date total return: 5.42%

Return since July 31, 2002, inception: 18.5%*

Data: PIMCO Funds *Institutional shares

Q&A

Heebner: Builders Still Have Hot Hands



Rising mortgage rates seem likely to cool the housing market and sink homebuilders' stocks. That's the conventional wisdom, but mutual-fund manager **G. Kenneth Heebner**, co-founder of Capital Growth Management (CGM) in Boston, says it's all wrong. Heebner, 62, has been buying the builders since 2001, and

they now represent 78% of his \$470 million CGM Realty Fund, which is up 46.2% this year. Heebner recently spoke with Dallas correspondent Stephanie Anderson Forest. Here are excerpts:

Most people are expecting a slowdown in housing. So why are you so bullish on the homebuilders' stocks?

The key reason is these companies are going to grow earnings 20% a year for the next five years. And they are going to do that whether housing activity goes up from here or sideways from here. The only thing that would interrupt this would be a big decline in the housing market.

Will rising rates and continued high unemployment do that?

A 30-year, fixed mortgage today is around 6.3%. In 2002, it averaged 6.7% and in 2001, over 7%. In those years, rates stimulated housing demand, so rates have to go a lot higher before they become an issue.

With employment, for example, there is a level of distress that

hurts demand. In Austin, San Antonio, and Dallas, where technology employment have suffered, demand has been hit. But in other parts of the economy, where unemployment has risen but not as sharply, demand has not been hurt.

Where will the 20% earnings growth come from?

The publicly traded homebuilders are well financed. They have a lot of publicly traded debt, which in many cases is investment-grade. They are diversified geographically, have management development programs, and build to order, not on spec. Most of all, these companies are gaining market share. The top 10 publicly traded homebuilders have a 21% market share, up from 5% in 1990.

How does that help them?

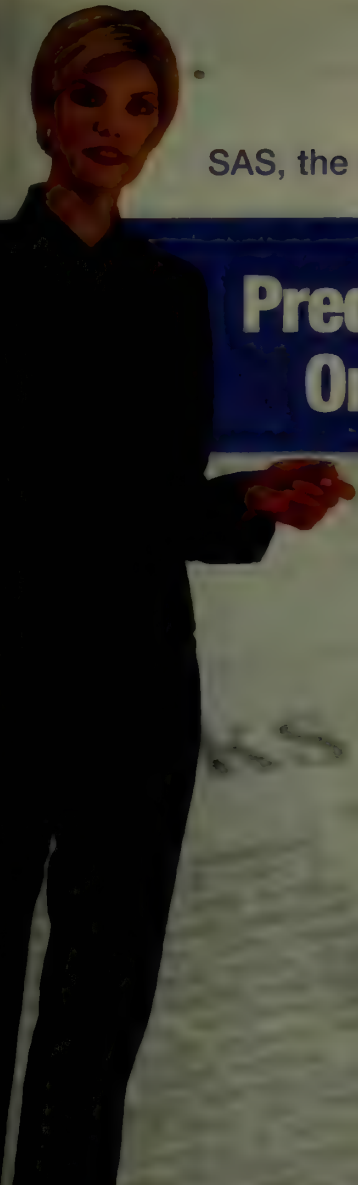
These companies have the money to buy the parcels of land that are increasingly scarce in the major metropolitan areas and in markets like all of California, Baltimore-Washington, and the Pennsylvania-New Jersey. In Orlando, the public builders control 20% of the market but control 50% of the land supply. The public builders get the most desirable land.

How many builders are in the fund?

I own most of them. I don't have a strong preference for one over another. They are all selling between six and seven times their earnings. It's hard to forecast which one will do best because they all are making acquisitions—and they are all very good.

What are some of the larger holdings in the fund?

Lennar, Hovnanian, Ryland Group, and NVR. Hovnanian, is well positioned on the East and West Coasts, is the biggest holding (11%) because of appreciation (up 94.5% this year). It goes up more, I'm going to have to sell some. I'm not going to become 20% of the fund.



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A PEEK INSIDE REDENVELOPE'S IPO

BY ROBERT BARKER rb@businessweek.com

QUICK, PUT IT ON YOUR CALENDAR. Sept. 7 is National Grandparents' Day. Just what we need, right, another occasion for gift-giving? Sometimes I imagine millions of Americans lining up at consumer-credit counseling offices and having to recount every nickel wasted on gifts not given from the heart.

Most folks don't seem so dismayed by all the manufactured occasions for largesse as I am. The latest evidence is RedEnvelope, a little company with big backers (giant Sequoia Capital, for one) and ambitions. Its stated goal is "to make gift giving—no matter what the occasion or circumstance—easy and fun." Now, the San Francisco retailer aims also to sell stock in a \$31 million initial public offering led by WR Hambrecht (table). As dyspeptic as I may be about giftmania—not to mention being uniformly skeptical of IPOs—this one may be worth investors' time looking into.

The place to begin is on the Net, where RedEnvelope got its start in 1997 as GiftWorks Online. Two years later, it adopted its current identity and signature red gift-wrapping. The Web site is easy to use, even if it pushes dubious stuff: a four-leaf clover pressed in glass (\$28); a branding iron to "monogram" barbecued steaks (\$65); a tin of "handcrafted" root beer (\$49); a range of Kama Sutra kits, with such items as edible honey dust and Love Liquid, from the Weekender (\$25) to the Pleasure Box (\$65). For Grandparents' Day, RedEnvelope suggests the Tingler, a \$20 acupressure tool promising "chills of ecstasy...oohs, aahs, and shivers of pure delight." Try explaining that to the grandkids.

Just the same, people are spending more and more money at RedEnvelope, which now has a database of 1.4 million customers, a third of them added in the past year. From \$8 million in fiscal 2000, revenue grew steadily, to \$70 million in fiscal 2003, which ended on Mar. 30. RedEnvelope remains unprofitable, but the red ink is fading. Net losses peaked in fiscal 2001, at \$26.5 million, and fell to \$7.7 million in fiscal 2003. In the current year's first quarter, losses sank 47%, to \$1.2 million. Better yet, cash flow from operations, at \$1.4 million, swung positive from a \$1.8 million burn last year.

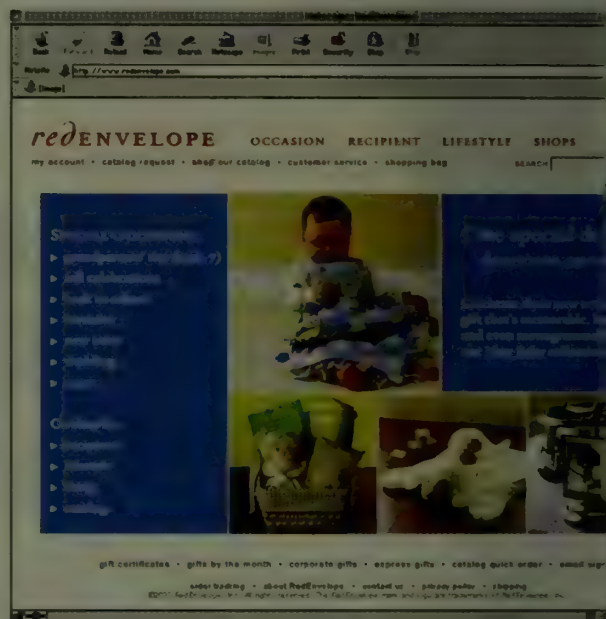
So the trends are up. Yet

RedEnvelope At a Glance

Revenues	\$72.5
Operating loss	6.1
Net loss	6.6
Indicated market cap	119
Tentative symbol	REDE
Home page	REDENVELOPE.COM

All financial data in millions, for 12 months ended June 29, 2003

Data: Company reports, BusinessWeek



HOT GIFT ITEMS:

Sales numbers are headed up at this online retailer

this holiday season, RedEnvelope is an extra risk. In August, the company stopped outsourcing its fulfillment, picking items from inventory, them, and shipping out customer orders at its one distribution center in California. In an Internet store, this is a critical move, and one in which RedEnvelope

has no experience. A spokeswoman, citing the IPO, declined to answer any questions about fulfillment.

So why pay attention to RedEnvelope? For one, with any growth in volume, the company figures to be profitable. More intriguingly, it's one of the few companies going public via Hambrecht's new OpenIPO process (wrhambrecht.com). In this, anyone with \$2,000 can open an account and bid (with a 100-share minimum order). Bidders win, but via OpenIPO you need not place a bid and hope for the best. You can set a ceiling on your bid.

The company, which is debt-free, estimates the stock will go at \$12 to \$16 a share. At the midpoint, \$14, it would command a market value of \$119 million, or 1.6 times last four quarters' sales. That may seem cheap next to sales on the Net and off, given that Amazon.com trades at 3.1 times sales and Tiffany 3.1 times. But a smaller specialist, such as 1-800-Flowers.com, which is growing slowly and trades at 1.1 times sales, is a better comparison. At that multiple, RedEnvelope would bring \$9.38 a share.

Will the IPO be priced so low? Unlikely, for two reasons. First, the market's recent buoyancy is stirring investor greed. Second, RedEnvelope's current owners paid \$13.47 for their stakes. If you can get the stock at \$10, consider it a gift.



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Monthly pages printed	Monthly operating costs only	Total monthly costs include hardware, 36-month warranty upgrade and operating costs with HP's currently offered 36-month, 0% FMV lease* special and Value Promotion rebates				
2,000	\$71	\$73	\$69**	\$68**	\$80	
3,000	\$106	\$99**	\$89**	\$80**	\$91**	
5,000	\$170	\$151**	\$130**	\$106**	\$113**	

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Paper capacity		200 sheets	250 sheets	350-850 sheets	600-2,600 sheets	600-2,600 sheets
Monthly duty cycle		20,000	10,000	50,000	150,000	200,000
Print resolution		300 dpi	1200 dpi	1200 dpi	1200 dpi	1200 dpi
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BY GENE G. MARCIAL

In Rude Health at UHS

Despite the inhospitable climate prevailing in hospital management, the industry's No.3, Universal Health Services (UHS), is in the pink, with earnings and revenues beating expectations. Its shares have soared, too—from 32 on Feb. 14 to 50 on Sept. 3. Some hospital outfits are under investigation for accounting fraud, scaring off investors. CEO Alan Miller, who formed Universal in 1978 with venture-capital backing, says: "We don't do any funny stuff with our numbers. We grow the old-fashioned way, through hard work and modest acquisitions." Like its rivals, Universal has been hurt by the soft economy, which has caused its share of uninsured and underinsured patients to rise. Nonetheless, says Miller, Universal, which owns and operates about 100 hospitals, has had 29% average returns for the past 10 years. Some analysts say the stock still has room to climb. Lori Price of J.P. Morgan Securities, who rates UHS "overweight," sees "compelling growth opportunities" and notes that it is trading at just 7.1 times her 2003 EBITDA estimates—below the industry average of 7.8 and well below 9.5 for Health Management Associates, its closest rival. In the next year, "Universal will outperform many of its peers," says Price. Her price target is 60. John Ransom of Raymond James & Associates says that, with Universal selling at just 14 times his 2003 estimate of \$3.26 a share on sales of \$3.6 billion and at 12.4 times his 2004 forecast of \$3.69 on \$3.9 billion sales, it is a "strong buy."



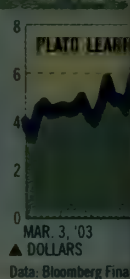
CEO MILLER

Why Plato Is Getting Good Marks

Even though school funding is scarce these days—with states in financial straits—shares of Plato Learning (TUTR) have more than doubled, from 3.39 in March to 7.34 on Sept. 3. Two reasons: Plato, which provides computer-instruction systems for middle school, high school, and college, should benefit when Uncle Sam frees up more money for schools, particularly as the 2004 elections near. And Plato is rumored to be takeover bait. "Plato, with its superb curricula for reading, math, and science, is compelling, trading at just one times sales—with no debt," says Eric Miller, managing director at Heartland Advisors, which has a 9.5% stake. In a consolidating industry, Plato

would be an attractive target, he argues, for major publishers. He believes Pearson or Reed Elsevier is looking to, which, he figures, is worth 12 a share, or \$201 million. Plato's current market cap is \$116.5 million. Miller expects Plato, which posted a loss in fiscal 2002 ended Oct. 31, to earn 7¢ a share in 2003 and 35¢ in 2004. Shane Glenn of investment outfit Dougherty is neutral on the stock but notes that, given its fixed-cost structure, Plato will get "significant improvements in earnings momentum" when funding and sales growth returns. A Plato spokesman says that despite the rumors, "the company isn't for sale."

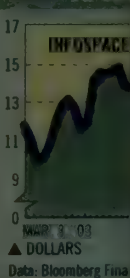
GOING TO THE TOP OF THE



At Infospace, Net Searches Are Clicking

Infospace (INSP), a hot Internet stock that flared when techs fizzled, has reignited: Shares have tripled, from 3.75 a year ago to 16.51 on Sept. 3. Management led by Jim Voelker took over in December 2002, and overhauled the company. Infospace's business is its search-and-directory unit: Through sites it helps users locate information, people, and businesses. Infospace charges advertisers a fee when a user clicks a search result or views a listing. Infospace generated 134 million paid searches in the second quarter. Its cash flow is on the rise as revenues heat up. In the first quarter, it posted \$1 million—but in the second, cash flow jumped to \$14 million. That's only half of the story: Suitors are eyeballing Infospace because of its strong balance sheet, low valuation relative to cash flow, tech assets, and \$300 million in cash, says Jonathan Cohen of JLC Capital Management. The company's search unit alone should bring in \$80 million in 2003, on growth of 25%. Stewart Barry of DeLafield Hambrecht also thinks Infospace may be a target of major Net players. He sees Infospace earning 47¢ a share in 2004 on revenue of \$144 million, and 77¢ on \$167 million in 2005. His price target: 21. Infospace declined comment.

SPRINGING TO THE TOP



BusinessWeek online Gene Marcial's Inside Wall Street is at businessweek.com/today.htm at the magazine's publication day, usually Thursdays. See Gene on FR 1:20 p.m. EST on CNNfn's *The Money Gang*.

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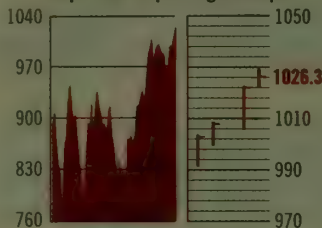
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S&P 500

Sept. Mar. Sept. Aug. 28-Sept. 3



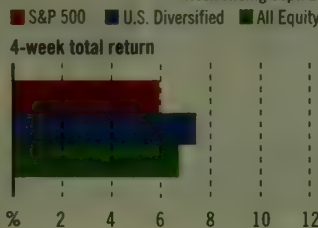
COMMENTARY

Investors returned from vacation and sent stocks soaring, brushing aside warnings from those who say that historically the month of September is a weak one for equities. Good news in tech is lifting all boats: Cisco's CEO said August sales were better than expected. For the week, the NASDAQ, S&P 500, and the Dow rose 4.0%, 3.0%, 2.5%, respectively.

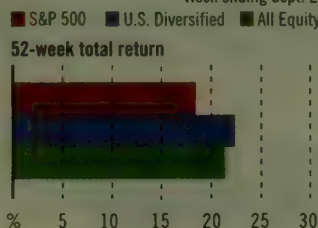
Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

Week ending Sept. 2



Week ending Sept. 2



Data: Standard & Poor's

U.S. MARKETS

	SEPT. 3	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1026.3	3.0	16.6	16.9
Dow Jones Industrials	9568.5	2.5	14.7	15.2
NASDAQ Composite	1852.9	4.0	38.7	46.6
S&P MidCap 400	525.7	3.2	22.3	22.3
S&P SmallCap 600	248.9	3.8	26.6	28.2
Wilshire 5000	9947.1	3.1	19.2	19.6

SECTORS

	SEPT. 3	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	585.8	2.8	8.2	6.3
BW Info Tech 100**	323.8	3.8	13.4	21.6
S&P/BARRA Growth	520.5	3.0	16.0	15.3
S&P/BARRA Value	502.2	3.0	17.3	18.6
S&P Energy	202.4	2.5	10.5	12.4
S&P Financials	346.3	3.1	16.6	15.4
S&P REIT	107.4	2.7	18.3	12.4
S&P Transportation	181.6	2.5	6.9	6.5
S&P Utilities	108.7	2.7	11.2	3.5
GSTI Internet	134.4	1.7	80.0	112.1
PSE Technology	642.7	3.2	40.2	50.1

*Mar. 19, 1999 = 1000

**Feb. 7, 2000 = 1000

BEST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Comptr. Stge. & Perphs.	22.7	Internet Software 246.4
Computer Retailers	21.3	Wireless Services 106.1
Tires & Rubber	18.7	Computer Retailers 103.0
Application Software	17.8	Comptr. Stge. & Perphs. 100.4
Fertilizers & Ag. Chems.	17.6	Internet Retailers 92.7

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS			
Japan	15.6	Technology	53.9
Precious Metals	12.7	Communications	41.6
Technology	12.6	Precious Metals	34.7
Diversified Pacific/Asia	11.1	Small-cap Growth	34.6
LAGGARDS			
Europe	1.1	Utilities	11.9
Real Estate	3.7	Domestic Hybrid	12.0
Domestic Hybrid	3.8	Miscellaneous	13.4
Health	4.1	Foreign	13.9

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS			
PFds. Smicdr. Ultsr. Inv.	28.9	PFs. Intnet. Ultsr. Inv.	218.8
Rydex Large Cap Japan	23.8	Jacob Internet	162.1
PFds. Ult. Sm. Cap Inv.	23.2	Amerindo Technology D	116.2
ProFunds UltraOTC Inv.	22.1	RS Internet Age	115.2
LAGGARDS			
American Heritage	-33.3	Frontier Equity	-68.7
Rydex Dynamic Vent. 100	-18.9	Rydex Dynamic Vent. 100	-67.9
PFds. UltSh. OTC Inv.	-18.8	PFds. UltSh. OTC Inv.	-67.8
Rydex Dyn. Tempest 500	-11.4	Potomac OTC/Short Inv.	-41.8

GLOBAL MARKETS

	SEPT. 3	WEEK
S&P Euro Plus (U.S. Dollar)	980.9	3.8
London (FT-SE 100)	4262.1	1.3
Paris (CAC 40)	3422.8	4.4
Frankfurt (DAX)	3647.5	4.7
Tokyo (NIKKEI 225)	10,715.7	3.9
Hong Kong (Hang Seng)	11,102.4	4.0
Toronto (S&P/TSX Composite)	7580.4	1.1
Mexico City (IPC)	7719.1	2.9

FUNDAMENTALS

	SEPT. 2	WK. AGO
S&P 500 Dividend Yield	1.62%	1.6
S&P 500 P/E Ratio (Trailing 12 mos.)	28.7	28.
S&P 500 P/E Ratio (Next 12 mos.)*	17.2	17.
First Call Earnings Revision*	0.02%	-0.2

TECHNICAL INDICATORS

	SEPT. 2	WK. AGO
S&P 500 200-day average	921.8	918.
Stocks above 200-day average	81.0%	78.0
Options: Put/call ratio	0.76	0.82
Insiders: Vickers NYSE Sell/buy ratio	4.29	4.03

WORST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Multi-line Insurers	-3.6	Health-Care Facilities
Managed Health Care	-3.0	Tires & Rubber
Pharmaceuticals	-1.8	Tobacco
Biotechnology	-1.7	Multi-Utilities
Soft Drinks	-1.4	Housewares & Spec

INTEREST RATES

KEY RATES

	SEPT. 3	WEEK AGO
MONEY MARKET FUNDS		
80-DAY TREASURY BILLS	0.62%	0.61%
2-YEAR TREASURY NOTES	2.00	1.97
10-YEAR TREASURY NOTES	4.60	4.53
30-YEAR TREASURY BONDS	5.35	5.31
30-YEAR FIXED MORTGAGE†	6.49	6.45

†Bank

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR BOND
GENERAL OBLIGATIONS	
	4.09%
TAXABLE EQUIVALENT	
	5.84
INSURED REVENUE BONDS	
	4.22
TAXABLE EQUIVALENT	
	5.03

THE WEEK AHEAD

INSTALLMENT CREDIT Monday, Sept. 8, 3 p.m. EDT ► Consumers are forecast to have tacked on an additional \$3.5 billion of debt in July, following a small \$400 million decline during June. That's according to the median forecast of economists surveyed by MMS International.

INTERNATIONAL TRADE Thursday, Sept. 11, 8:30 a.m. EDT ► The foreign-trade deficit probably rose to \$40.5 billion in July. Both exports and imports are expected to have increased, with imports posting a larger gain. In June, the trade deficit declined to \$39.5 billion.

EXPORT-IMPORT PRICES Thursday, Sept. 11, 8:30 a.m. EDT ► Export prices probably rose 0.3% in August, following a small 0.1% fall in July. Import prices very likely climbed 0.2%, after a 0.5% jump in July.

RETAIL SALES Friday, Sept. 12, 8:30 a.m. EDT ► August retail sales are expected to have increased 0.4%, after surging 1.4% in July. Minus vehicles, sales probably rose 0.5%, following a 0.8% gain in July.

PRODUCER PRICE INDEX Friday, Sept. 12, 8:30 a.m. EDT ► Producer prices most likely increased 0.3% in August, after a

small 0.1% rise in July. Excluding food and energy, prices probably rose for a second straight month.

The *BusinessWeek* production index fell in the week ended Aug. 23, up 2.9% year ago. Before calculation of the 12-month moving average, the index moved up 1.1%.

BusinessWeek online

For the BW50, more investment data, and components of the production index, visit www.businessweek.com/magazine/

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Michael T. Rose Companies, Michael T. Rose
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Panasonic/Matsushita Electric Corporation of
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Sears, Roebuck and Co., Alan J. Lacy
Slade Gorton & Co. Ltd., Michael Gorton
State Farm Insurance Companies,
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Index to Companies

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

A

Actiontec Electronics **27**
adidas-Salomon **56**
AECOM Government Services **68**
AirTran Holdings (AAI) **93**
Allianz **54**
Amazon.com (AMZN) **110**
Amerada Hess (AHC) **59**
AmerGen Energy **12**
American Airlines (AMR) **18**
American International Group (AIG) **54**
America Online (AOL) **27, 80**
AM General **12**
AOL Time Warner (AOL) **12, 44**
Argus Research **44**
Avon Products (AVP) **84**

B

BadBlue **80**
Bank of America (BAC) **40, 50**
Bank One (ONE) **40, 50**
BMW **104**
Boeing (BA) **93**
Bomatic **46**

C

Canary Capital Partners **40, 120**
Capital Growth Management **108**
Card Access **27**
China Kejian **56**
Chiyoda Mutual Life **54**
Chrysler Group (DCX) **50**
Cintas (CTAS) **64**
Cisco Systems (CSCO) **32, 36, 48**
Citigroup (C) **48**

Coast Converters 46

Compus Computer **18**
Computer Associates (CA) **84**
Computer Sciences (CSC) **68**
ConocoPhillips (COP) **59**
Continental Airlines (CAL) **50**
Credit Suisse First Boston (CSR) **12**
Cypress Group **12**

D

Delafield Hambrecht **112**
Dell (DELL) **36, 48, 50**
Delta Air Lines (DAL) **93**
Dial (DL) **36**
Direct Connect **80**
Dominion Resources (D) **12**
Dougherty **112**
Dyncorp (CSC) **68**

E

EarthLink (ELNK) **27**
Enron (ENRNQ) **42, 120**
Entergy (ETR) **12**
Exclusive Resorts **102**

F

Fidelity Investments **12**
First Quadrant **106**
Flextronics International (FLEX) **36**
Ford (F) **12, 50**
Four Seasons Hotels (FS) **102**
Fuji Fire & Marine Insurance **54**
Fuji Photo Film (FUJIIY) **56**

G

Gallup Poll **52**
Gartner **29**
Gateway (GTW) **50**

GE Edison Life 54

GE Medical Systems (GE) **44**
General Electric (GE) **32, 44**
General Motors (GM) **32, 50**
GlaxoSmithKline (GSK) **80**
Groove Networks **80**

H

Hain Celestial Group (HAIN) **50**
Halliburton (HAL) **68**
Harbour & Associates **32**
Harbrew Imports **56**
Harris Poll **52**
Health Management Associates (HMA) **112**
HealthSouth (HRC) **42**
Heartland Advisors **112**
Hewitt Associates **84**
Hewlett-Packard (HPQ) **80**

Hiler Industries **34**
H.J. Heinz (HNZ) **50**
Home Depot (HD) **84**
Honeywell International (HON) **93**
Hotels.com **50**

I

IBM (IBM) **12, 18, 36**
ICQ **27**
Imclone **42**
Infospace (INSP) **112**
Instrumentarium **44**
Intel (INTC) **36**

J

Janus Group **40**
JLC Capital Management **112**
J.P. Morgan Chase (JPM) **32, 50, 112**

K

Kellogg Brown & Root (HAL) **68**
KPMG **12**

L

Lamps Plus **36**
Lek Securities **84**
Liquidnet **84**
Longleaf Funds **12**
L3 Communications (LLL) **68**

M

McGraw-Hill (MHP) **48**
MediaDefender **80**
Medical Manager (HLTH) **50**
Mercedes-Benz (CDX) **104**
Merrill Lynch (MER) **32, 48, 84**
Microsoft (MSFT) **12, 18, 36, 48**
Military Professional Resources (LLL) **68**
Mirabella Estates **102**
Morningstar **12, 40**
Motorola (MOT) **56**
MSN (MSFT) **27**

N

NBC (GE) **18, 44**
Newhouse News Service **58**
Nike (NKE) **56**
Northrop Grumman (NOC) **68**
Northwest Airlines (NWAC) **93**

O

Odyssey Club **102**
Ogilvy & Mather Worldwide **56**
1-800-Flowers.com (FLWS) **110**
Oppenheimer Real Asset Fund **106**

Oracle (ORCL) **12, 48**
Orbitz **32**

P

Pearson & Reed Elsevier **112**
PepsiCo (PEP) **56**
Philips Electronics (PHG) **56**
Pimco All Asset Fund **106**
Pimco Commodity Real Return Strategy Fund **106**
Pimco StocksPLUS Fund **106**

Plato Learning (TUTR) **112**
PoliticalMoneyLine.com **62**
Precursor Group **36**
Private Retreats **102**
Procter & Gamble (PG) **32**
Prudential (PRU) **54, 84**

R

Raymond James & Associates **112**
RedEnvelope **110**
Renco Group **12**
Ritz-Carlton Hotels **102**
Roadwired.com **99**

S

SAP America (SAP) **36**
SBC Communications (SBC) **36**
Sequoia Capital **110**
Siemens (SI) **56, 80**
Smith Barney (C) **12**
Sony (SNE) **102**
Southwest Airlines (LUV) **93**
Standard & Poor's (MHP) **44, 48, 54**
State Farm **28**

Strong Capital Management
Sun Microsystems (SUNW) **12**

T

Tata Group **54**
Tech Valley Home Estate **100**
Telemundo Communications (GE) **44**
Thomson Financial
Tiffany (TIF) **112**
Travelocity.com

U

UBS Warburg
Unifi (UFI) **34**
Universal Health Services (UHS)

V

Verizon (VZ) **36**
Viacom (VIA) **84**
Vinnell (NOC) **112**
Virgin Atlantic
Vivendi Universal
Volkswagen **104**

W

Wachovia (WB)
Wal-Mart Stores **32**
WebMD (HLTH)
Wells Fargo (W)
WorldCom **42**
WR Hambrecht

X

Xerox (XRX) **112**

Y

YachtSmart **112**
Yahoo! (YHOO)
Yanjing Beer

Z

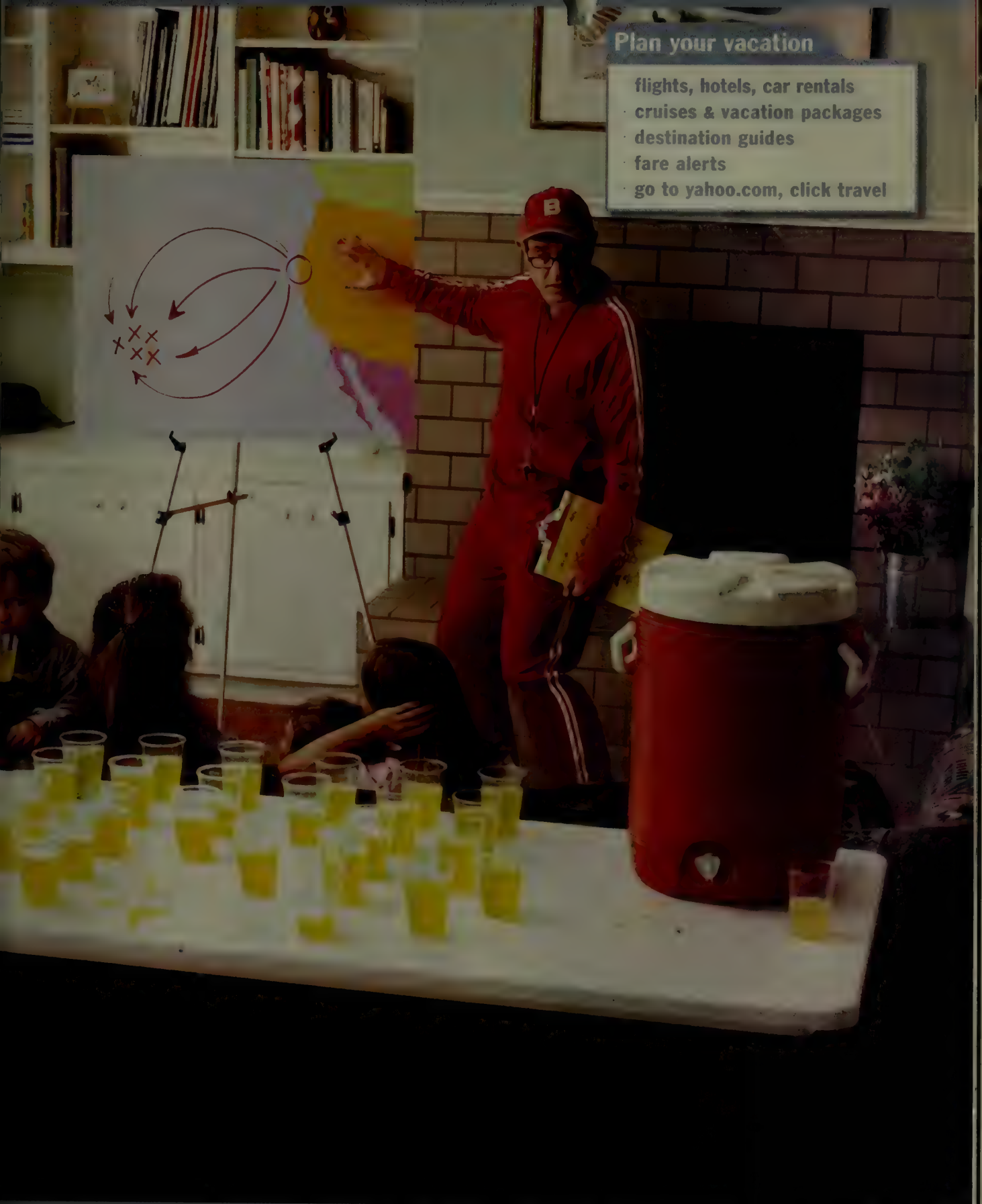
Zeropaid **80**
Zou Marketing

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CONGRESS: WHERE IS THE SENSIBLE CENTER

The political season is upon us. Congress is back from summer recess, and the 2004 Presidential campaign has already begun. A nation that increasingly retreats from the middle ground of pragmatism, compromise, and negotiation promises to become even more ideologically polarized. Both political parties have decided to seek victory by abandoning the broad swath of independent swing voters to focus on energizing their base. That can only mean more political partisanship in the months ahead as Congress grapples with important policy issues.

The timing couldn't be worse. The economy is finally showing signs of liftoff as CEOs and consumers feel more confident in the future. But to maintain the new economic momentum, Americans also need to have confidence that their political system can manage serious problems. Right now, there are domestic and foreign policy issues that appear out of control. Congress and the White House need to get real to get things done. Here's the agenda:

■ **Energy.** The current energy legislation before Congress is unbalanced and unfocused. It relies too heavily on measures to encourage oil and gas production but is light on measures to promote conservation. Relaxing certain regulations and opening some public lands to more oil and gas exploration makes sense. But so does encouraging Detroit to increase fuel economy standards. One easy step is for Washington to seriously promote available hybrid engines that offer twice the mileage of traditional gas engines. Another is to break out legislation bolstering the transmission grid from the energy bill and pass it.

■ **Iraq.** It is clear that rebuilding the country is going to require far more money and troops than anticipated. Unless the U.S. is willing to increase the size of its army and pour tens of billions of additional dollars into the country, it needs

to share the burdens and responsibilities of rebuilding. It's time to bring in the U.N. The U.N. failed to stop bloodletting in the Balkans, leaving the task to the U.S. but it has since done a good job in providing soldiers and aid to rebuild Bosnia and Kosovo. The U.N. can help cure the city streets in Iraq while the U.S. pursues Hussein and terrorists. The U.N. is offering the U.S. an arrangement under which all troops in Iraq would report to an American general. Washington should do the deal now.

■ **Deficits.** The budget is out of control. There are few signs of spending in Washington, and the soaring deficit may reach 4% or more of gross domestic product through the end of the decade, at which time the baby boomers begin to retire. The deficit figures do not include additional billions for a new Medicare drug benefit, ending the alternative minimum tax, or the overseas war. Enough already. Means testing the Medicare drug prescription benefit so that only those who cannot get it subsidized. Share the financial burden of Iraq with Europe and Asia. And reexamine some of the tax cuts so that Social Security and Medicare don't bankrupt the nation.

America's political system is becoming more polarized and partisan even as most voters become less ideological. The system is more independent. Ideology has defined the debates on energy, the budget, and the war in Iraq. A rational, independent approach in Washington acknowledging the leadership and contribution of both conservatives and liberals would be in the best interest of America. The economy is at a critical point in its recovery. The temptation in this political season to go to extremes threatens to undermine the confidence in the economy needs to keep moving forward. Politicians must pay a stiff price if they hurt the liftoff.

ELIOT SPITZER, ONCE AGAIN

Hooray for the state AGs. New York State Attorney General Eliot Spitzer's latest investigation reveals illegal trading schemes between hedge and mutual funds that may be costing mutual-fund shareholders billions of dollars (page 40). Canary Capital Partners has settled with Spitzer, without admitting guilt, agreeing to return \$30 million in illegal profits to shareholders in four mutual funds, pay a \$10 million fine, and cooperate in an industry-wide investigation. The sums are small next to Spitzer's earlier triumph, a \$1.4 billion settlement from Wall Street firms for slanting research to win investment banking business while misleading small investors. But they may be just the beginning.

Where is the Securities & Exchange Commission in this reform effort? True, no government agency has the formal mandate to regulate hedge funds, even though they play a powerful and growing role in the markets. But the SEC does have authority over mutual funds. Why did it leave it to a

state AG to oversee the mutual-fund industry, just as it did with Wall Street research? To his credit, SEC Chairman William Donaldson has done a good job in reestablishing the regulatory agency's credibility after the lax tenure of Arthur Levitt during the wave of corporate scandals. He has launched studies on mutual-fund disclosure and whether or not hedge funds need regulation. But he has been acting while the SEC has been studying.

The SEC should dig deep into mutual funds' activities and draw up a set of rules for hedge funds. And both the SEC and the Justice Dept. have to finally bring charges against the executives who led Enron and WorldCom. Oklahoma Attorney General Drew Edmondson is poking his finger in the eye of the SEC by going after WorldCom's Bernie Ebbers. Once again, the state AGs who are the heroes to individual investors. Washington doesn't want 50 Eliot Spitzers making policy. It better make sure the SEC and Justice do their jobs.

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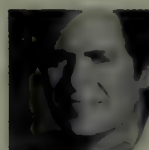
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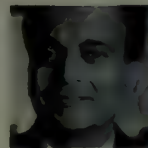
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WHAT'S AN **MBA** REALLY WORTH?

In an exclusive survey of
B-school alums, the class
of '92 grades the degree.

- ▶ Salaries ▶ Satisfaction
- ▶ Alumni Networks

PAGE 90

Sallie Krawcheck
Chairman and CEO
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A dark, rectangular object, possibly a piece of furniture or a sculpture, is positioned on a light-colored tiled floor. The floor has a grid pattern. The background is a dark, textured wall or ceiling with several square, recessed lights. The word "Reactive" is overlaid in a large, white, sans-serif font.

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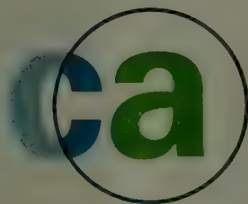
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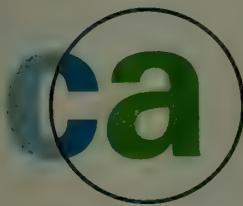
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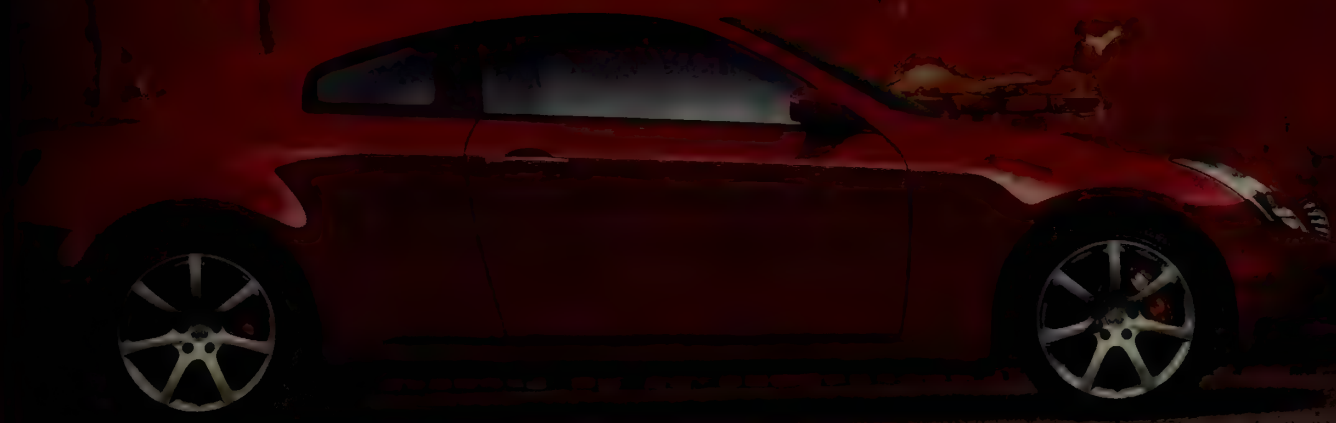
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COVER STORY

WHAT'S AN MBA REALLY WORTH?

The degree has come under fire lately—but the Class of '92 says it helped them carve the careers they wanted

page 90

BusinessWeek

SEPTEMBER 22, 2003

Cover Story

90 WHAT'S AN MBA REALLY WORTH?

A lot, say the 1,500 alums of the Class of '92 surveyed by *BusinessWeek*. Some 89% say they would go for the degree again if they had to do it over. And why not? Their salaries and bonuses are hefty, and they occupy, after only a decade, top posts in their companies. Today, members of the class earn an average salary of more than \$155,000—up from the average \$56,600 they earned in the first post-MBA job

94 CRUNCHING THE NUMBERS

How BW conducted its MBA survey

96 RAKING IT IN

Big salaries—and some really big bonuses—for the Class of 1992

98 THE ENTREPRENEURIAL URGE

Not all MBAs are content to climb the corporate ladder

News: Analysis & Commentary

28 A MOST COSTLY WAR

The billions needed for Iraq could take a toll on the economy—and on the President's political fortunes

30 A TALK WITH COLIN POWELL

The Secretary of State's job isn't getting any less stressful. He explains why he remains upbeat

32 COMMENTARY: IRAQ

The Bush Administration is learning some tough lessons about the cost of going it alone

36 READY TO HIRE?

All the pieces appear to be in place to throw this recovery's job engine into gear

38 COMMENTARY: THE UAW

The union may give Detroit some relief from its massive cost burdens—but that may not be enough

40 FLYING JUST A TAD HIGHER

But while they had a good summer, U.S. airlines are still struggling

42 IN BUSINESS THIS WEEK

International Business

46 BANKING: THE ECB

The new head of the European Central Bank, Jean-Claude Trichet, may engineer substantial changes

48 GERMANY: THE WORKFORCE

Young employees balk at shouldering the financial burden of a fast-growing cohort of retirees

50 AFGHANISTAN: RECONSTRUCTION

Can the Afghans create civic order before the first scheduled for next June

63 INTERNATIONAL OUTLOOK

Beijing has responded to provocative moves by the U.S. long will it keep playing

Economic Analysis

24 ECONOMIC VIEWPOINT

Tyson: A new governor what California really needs

25 BUSINESS OUTLOOK

U.S.: Despite continued consumer spending roar Brazil: Economic growth nowhere on the horizon

Government

45 WASHINGTON OUTLOOK

Can Dean the front-runner play the maverick?

Media

66 COMMENTARY: THE FCC

While Chairman Powell setback, his deregulatory may well survive



AIM...
Scientific's
y soon grab
om J&J page 86

FUNDS
Restore faith
mutual-fund
page 106



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ts an FDA nod. And don't
the Justice Dept. probe



- A rustic paradise
in Laos page 120
- Shanghai
surprises page 122
- St. Petersburg's
winter delights page 124
- Barker: Abbott's
bouncing baby page 131



ON THE RECORD
A conversation with
Colin Powell page 30



HELP WANTED?
The job market
could be turning the
corner soon page 36

CHANGE AGENT
How Sarbanes-Oxley
has and hasn't



sparked
reform
page 80



R&D REVISITED
More companies are
pulling together
to innovate page 74

Finance

106 MUTUAL FUNDS IN CRISIS

We've placed \$7 trillion worth of
trust in funds, but now scandal and
high fees are shaking that faith.
Here's what needs to be done

112 COMMENTARY: HEDGE FUNDS

Four ways to limit the damage the
funds can do

114 THE SEASON FOR CRASHES?

Some analysts see a big correction

BusinessWeek Investor

119 DIVIDENDS

Fast-growing food groups; public-
speaking venues; millionaire angst;
quick-recharging batteries

120 THE ALLURE OF LUANG PRABANG

An unspoiled town in Laos turns
the clock back to the 19th century

121 GO EAST—FOR A SONG

Airfare bargains in Asia

122 SPARKLING SHANGHAI

It's old, it's new, and in the wake of
SARS, discounts are widespread

124 PARTY LIKE A CZAR

Winter is invigorating in St.
Petersburg, Russia

126 PENGUINS ON PARADE

Watching their rituals is a popular
pastime in Australia

128 EXPLORING BAJA BY BOAT

On a crewed sail, you can kayak,
snorkel, or just laze around

130 DOING DISNEY WORLD RIGHT

A visit to the Orlando park doesn't
have to be an ordeal for grownups

130 NAPA BEYOND WINE

Several cultural institutions offer
exciting exhibits

131 THE BARKER PORTFOLIO

Abbott Labs' baby might outdo its
parent

132 INSIDE WALL STREET

Features

12 UP FRONT

16 READERS REPORT

17 CORRECTIONS & CLARIFICATIONS

18 BOOKS

Kidder: *Mountains Beyond
Mountains*

136 FIGURES OF THE WEEK

138 INDEX TO COMPANIES

140 EDITORIALS

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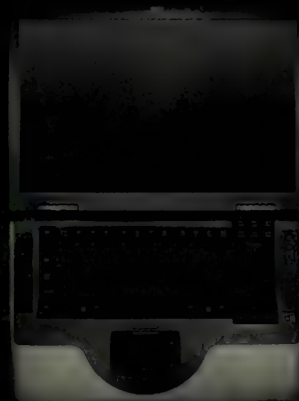
Your wireless notebook says you don't have to do it from your desk.

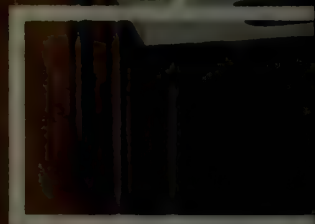
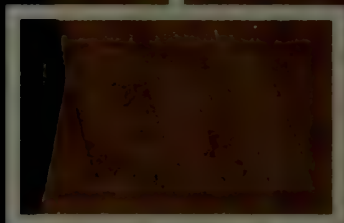
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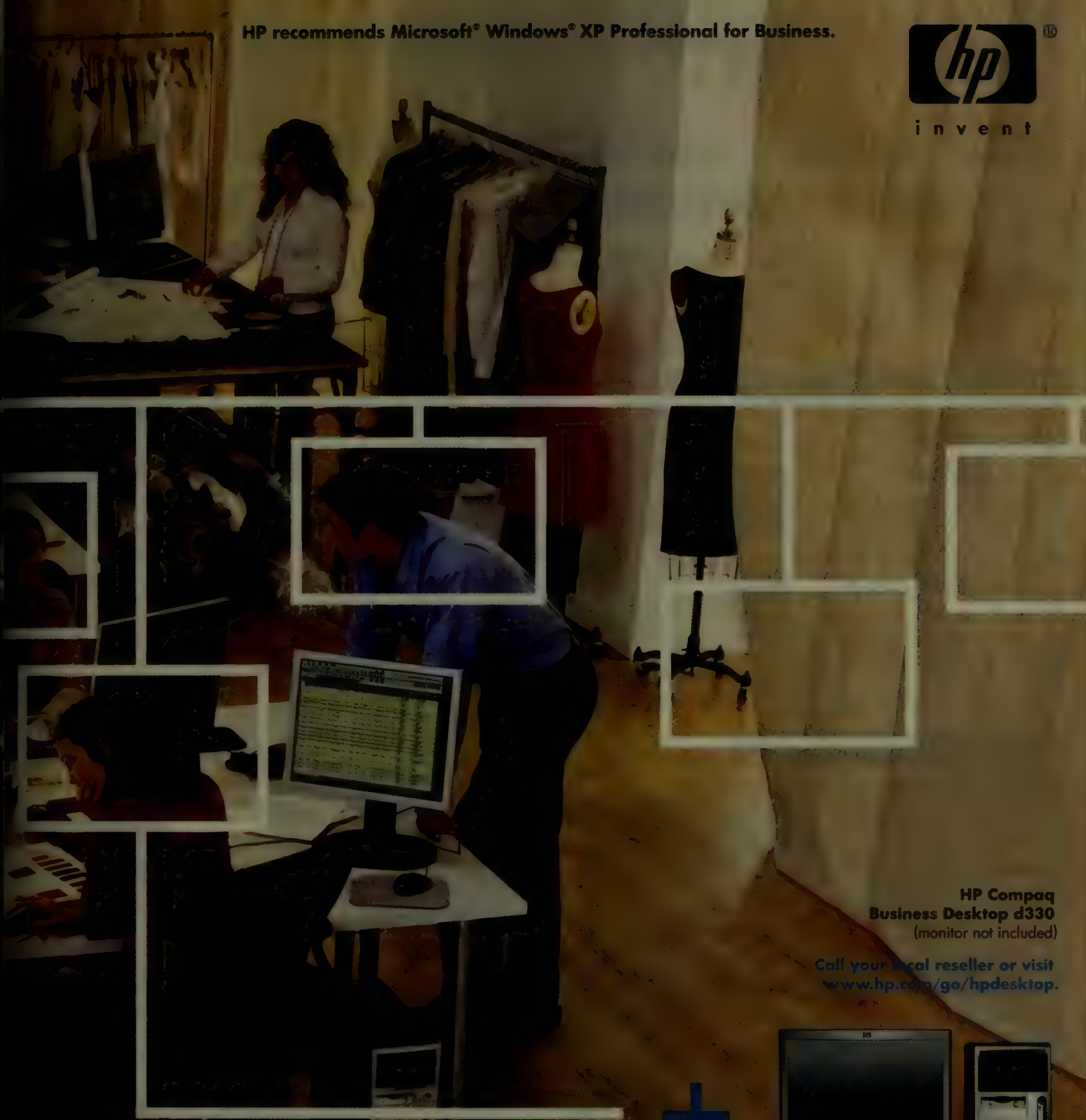
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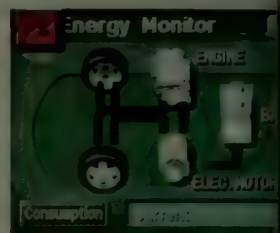
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High-Tech Cars

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Up Front

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FUND FRONT

EAGLE EYES ON PRUDENTIAL

WOE IS PRUDENTIAL FINANCIAL. Brokers at the Boston office are being investigated by the Massachusetts Secretary of the Commonwealth for questionable trades of mutual-fund shares. And *BusinessWeek* has learned that the firm's new stock-rating system violates one of the first rules adopted by the NASD to clean up Wall Street's research mess.

On Sept. 8, Prudential changed its analyst rating categories to "overweight,"

you were saying buy, hold, and sell," says Charles Hill, research director at Thomson First Call.

After being contacted by *BusinessWeek*, Prudential blamed its failure to explain the new ratings on a production error. The firm said it will make its ratings system clearer in future reports. The NASD declined to comment.

Prudential's other troubles may be harder to fix. Since early July, William Galvin, Massachusetts' Secretary of the Commonwealth, has been investigating individual brokers in the Boston office.

Galvin has issued a subpoena seeking documents from Prudential. He also sent letters to five mutual-fund companies, including Eaton Vance, asking for details on broker trading. Galvin is looking into whether a dozen top brokers hid their identities to buy and sell large blocks of mutual-fund

shares over short periods of time—a practice called market timing. It isn't illegal, but if the traders hid their actions, they violated state laws prohibiting fraud. "We think there was deceptive trading going on," says an investigator.

The Securities & Exchange Commission also is looking into Prudential's trading. The agency declined to comment. Prudential and Eaton Vance say they're cooperating with the probes. *Emily Thornton and Faith Arner*



MASSACHUSETTS' GALVIN

"neutral," and "underweight." That's O.K. But under rules adopted by the NASD last August, firms must explain in their analyst reports how the terms relate to the three-tiered rating system of "buy," "hold," and "sell."

Prudential didn't. In a report issued on Sept. 10 about Unilever, it only says that "underweight" means that a stock isn't expected to perform as well as other stocks in the same sector. "The idea was to make it clear when

TALK SHOW "I put this behind me....I am not going to debate the issue, or the size of future payments."

—New York Stock Exchange Chair Dick Grasso, declining an additional \$48 million on top of his \$140 million compensa-



AFTERLIVES

'YOU'VE GOT PINEAPPLES'

STEPHEN CASE, GENTLEMAN pineapple grower? It's not so crazy when you consider that Case grew up in Hawaii. Since resigning as chairman of AOL Time Warner in May, he has been stepping up his investments back home. In late July, Case boosted his

CASE: Big stake in plans in Land & Pineapple in Hawaii to 43.5% from 41.5%, according to SEC filings. He has announced plans to increase his stake to 43.5%.

Case, who has \$500 million in AOL Time Warner stock and options, already owns two private companies in Hawaii—Grove Farm and Lihue Plantation, both sugar plantations.

He believes Hawaii's pineapple business, badly battered by global competition, need retooling. His focus will be on developing profitable agricultural products, emphasizing fresh pineapples over canned, developed organic products," Case wrote in an e-mail to *BusinessWeek*.

In August, Maui hired former AOL executive Cole as CEO. Cole says Land also plans to invest in resort development and agriculture. Maybe that will prove easier than the synergy Case tried in East. *Catherine*

POLITICS

A SUDDEN DOWNPOUR OF GUV LOVE

IT'S THE POLITICS OF FEAR. California Governor Gray Davis, facing an Oct. 7 recall, is signing bills at a furious pace. Coincidentally, many benefit the voting blocs he desperately needs to stay in office.

On Sept. 5, Davis allowed illegal aliens to register for driver's licenses, which immigrant groups had long sought. Last year, he vetoed a similar bill. His rationale: Aliens who would drive anyway will at least have to show they know the rules of the road. Davis had battled consumer groups over legislation preventing the sale of personal data by finan-

cial institutions. Then, on Sept. 27, he signed the nation's broadest privacy bill, though he once vetoed similar legislation. Davis now favors legislation preserving land sacred to some Indian tribes. "It is about compromise and negotiation," says Davis spokesman Russell I.

Will all that love help? Polls show that 58% of voters favor the recall. Davis now faces \$3 million in fines from Governor Cruz. Davis. Even supporters see Davis as a flip-flop. "Not like a recall to your attention," says Davis' Democratic consultant Sragow. How many Davis gets may well depend on how many bills are signed. *Christopher F.*



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Up Front



HEALTH CARE

DOCTORS JUMP INTO THE INSURANCE POOL

SOME DOCTORS BELIEVE THEY have an antidote to the spiraling costs of malpractice insurance—self-insurance pools. Doctors say these efforts, known jokingly as “bedpan mutuals,” can charge lower rates because of their non-profit status, unwillingness to settle frivolous claims, and refusal to insure riskier doc-

tors. “It’s the perfect marriage of medicine and insurance,” says Steven Salman, CEO of Healthcare Underwriters Group of Florida, a doctor group hoping to launch by November.

According to *The Risk Retention Reporter*, an industry trade publication, 11 doctor groups have either filed to form or have formed their own insurance pools in the past 20 months. That’s as many as in the previous 15 years.

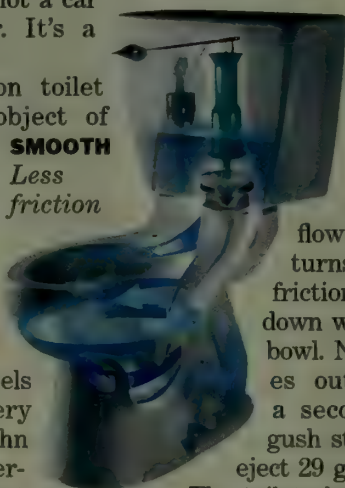
Still, some insurance execs question whether doctors are setting themselves up for even larger losses down the road from jury awards that are bigger than their capital reserves. “If other insurance companies are already losing money, how do they think they can charge less and survive?” asks Donald Zuk, CEO of SCPIE Holdings, a California malpractice insurer. By then, it could be too late for a second opinion. *Dean Foust*

ECO TRENDS

A POTTY WITH POWER

COMING SOON: A NEW PRODUCT that’s all about speed and power. No, it’s not a car or a computer. It’s a toilet.

The 1.6-gallon toilet has been an object of derision since **SMOOTH** the mid-1990s, *Less friction* when new toilets were limited to only that much water per flush, down from 3.5 gallons. “The early models didn’t work very well,” says John Koeller, a water-utility consultant. While low-flow toilets have improved, some consumers are still dissatisfied.



American Standard says its new Champion took two years to develop and flushes fully and reliably. “Is this like going to the moon?” says CEO Fred Poses. “No. But it’s a big improvement.” The toilet will cost roughly \$300, about \$100 more than the company’s other models.

Its big innovation? A water flow that gets rid of turns and points of friction that can slow down water leaving the bowl. Now, water rushes out in less than a second, creating a gush strong enough to eject 29 golf balls at once. The toilet also has been tested on water-filled *SpongeBob* toys and cloth napkins—but not on goldfish. *Amy Barrett*

DRAWN & QUARTERED



I-WAY PATROL

THE BAGGAGE AT TRAVELWEB

IS TRAVELWEB IN TROUBLE? The most recent sign of problems at the hotel-reservation Web site surfaced in the Aug. 28 IPO filing by Orbitz.com, which sells rooms for the year-old company. Travelweb is majority-owned by Hilton, Marriott, Hyatt, InterContinental, and Starwood. The Orbitz IPO filing says Travelweb has failed to live up to an agreement to supply the lowest rates available online for hotels run by Travelweb’s owners. Orbitz “isn’t happy, that’s for sure,” says analyst Lorraine Sileo of market

researcher PhoCusW

The Orbitz flap is just the latest sign that Travelweb is struggling. The online travel site drew 1.7 million visitors in July, just 11% of rival Expedia’s total, says Nielsen Ratings. And it has been without a CEO since Aug.

Jayne Allison, Travelweb’s general counsel, says Orbitz doesn’t require the lowest prices all the time. She says the charge is possibly because Orbitz declined to comment.

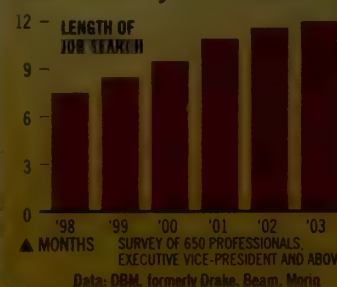
Travelweb’s board has approved a new marketing campaign to boost business. It has a short list of prospects. With Web squeezing hotel profits, it has little time to dawdle.

Timothy M. ...

THE BIG PICTURE

STILL SEARCHING

The economy is showing signs of strength, but senior execs endure longer job searches now than they did while the economy was officially in recession.



Polls, surveys, and other items for consideration in this section should be sent to upfront@businessweek.com

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MIND-BENDING ALTERNATIVES TO MEMORY PILLS

While we all would love to see a pharmaceutical panacea to eradicate such disorders as Alzheimer's disease, I believe the best approach is a preventive one ("I can't remember," Cover Story, Sept. 1). Common sense suggests that proper diet, moderate physical exercise, a lowering of environmental stress, and regular mental challenges would be of greatest value. Various studies support this. Fred H. Gage and Peter S. Eriksson, both neuroscientists, collected the first convincing evidence that the brains of humans, including the elderly, regenerate neurons in the hippocampus. Dr. Elizabeth Gould of Princeton University has shown that participation in a learning task enhances the survival rate of new nerve cells, resulting in an elevation in the number of new neurons.

You also identified continued mental activity as potentially providing a protective effect. In fact, the ACTIVE study, published in the *Journal of the American Medical Association* in 2002, demonstrated that 87% of elderly subjects who performed a mere 10 hours of speed-of-processing exercises on a computer actually reversed 18 years of age-related cognitive decline.

Dennis McCracken, M.D.
Nashville

My question to the authors and the developers of this new class of wonder drugs relates to the Law of Unintended Consequences. Will students competing on the SATs or preparing for final exams have a competitive advantage if they take this class of drugs? Will others involved in memory-intensive fields also find competitive advantage? Does this class of drugs have the potential to create an uneven playing field between the

haves, who can afford to purchase drugs, and the have-nots?

Henry A.
University Park

"I can't remember" refers to a Pfizer product. It was discovered and developed by Eisai Co. in Japan and is co-promoted in the U.S. by Eisai and Pfizer Inc.

Judee
Eisai
Teaneck

As a neurofeedback therapy works on enhancing performance by realizing that people rarely focus on a task at hand, but rather several tasks simultaneously. We can train the brain to focus on and perform a single task to enhance memory by strengthening memory areas of the brain. Ideally, we should learn to empower ourselves rather than reaching for a drug to "fix" the problem.

Sandy Lam
Lincoln

Originally, I started using neurofeedback for Parkinson's disease and found that it helped not only in restoring movement (including a decrease in tremors) but also in mental sharpness. The best part: no side effects.

Lisa T.
San Francisco

I must thank author Catherine Moore who writes [that] those French lessons forced on you as a child might pay off. As a French teacher, despite student moans and groans, I now have medical and health knowledge to support my passion: *Le français bon pour la santé!*

Jo D. Tane
Tallahassee

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DIRECTIONS & CLARIFICATIONS

the table "Memory magic" accompany-
"I can't remember" (Cover Story, Sept.
the target of Saegis Pharmaceuticals'
is described incorrectly. It blocks a
transmitter that can inhibit memory
olidation.

hunting buried treasure by GPS" (Busi-
Week Investor, Sept. 1), we printed the
g address for the most popular Web
It should be geocaching.com.

ING THE PUBLIC BACK PUBLIC UTILITIES

ce *BusinessWeek* has been the pri-
sentinel in the public community
high ethical and moral standards,
nes as a shock to read "Political
r overload" (News: Analysis &
mentary, Sept. 1). Peter Coy
s out the central issue, which is
systematic attack on the principle
blic utilities by the Administra-
with the timid acquiescence of
members of Congress.

has taken several centuries to form
basic ingredient of modern civiliza-
The public utility is granted a mo-
stic, guaranteed market together
the necessary access (by eminent

domain where needed). The Administra-
tion wants to continue all the perks for
the energy people but turn loose the
fee structure for robber-baron pricing
for "all the traffic will bear."

Vice-President Dick Cheney forms
an energy advisory group, composed
entirely of energy people, its member-
ship secret, its conclusions not released.
And a very large number of unelected
decision-makers are drawn from En-
ron and from the group who were con-
victed and then pardoned in the Iran-
contra affair. They control policy and
"enforcement."

BusinessWeek, we need you to be
guardians of the public interest more
than ever before.

Ward McCabe
San Jose, Calif.

Legislators and regulators have lost
sight of the utility as being as essential
as law enforcement to the well-being of
the community. Their failure to work
with the utilities to determine fair and
equitable ways to reward them for
building and maintaining a reliable sys-
tem with reasonable prices and returns
only encouraged short-term, bottom-line
thinking in the executive suite.

New electricity transmission lines
are generally not viable investments
under current regulation and pricing, so

there should be no surprise that few
are being built.

Victor Barry
Utilities International Inc.
Chicago

THINKING OUT OF THE BOX FOR CHINA'S DREAM TEAM

I was encouraged to read about revo-
lutionary opportunities reaching farm
boys like Sun Yunbo ("China's dream
team," Design, Sept. 1), only to find that
their prospects are less promising be-
cause of a "reluctance to speak out" at
brainstorming sessions. Perhaps we
could ask the "blazingly smart" and
"dedicated" designers in your report to
develop a revised format for brainstorm
sessions, rather than limiting this valu-
able resource to our own culturally ac-
cepted style of teamwork design.

Cheryl Conant Abrahms
Vista, Calif.

DON'T DEMONIZE COCA-COLA

It was puzzling to read that Coca-
Cola Co. derives 72% of its operating
profit from "fatty foods" ("The list: Fat
profits," Up Front, Aug. 18-25). Virtually
all of our beverages have no fat. Our
new milk-based product, Swerve, meets

1) Conceive



2) Scan



ricoh.com/share

the American Heart Assn.'s certification requirement for saturated fat and cholesterol. If you actually meant that our beverages cause people to become fat, I am equally puzzled. No single food causes obesity. All foods can fit in a healthy lifestyle, including soft drinks. The key to managing your weight is to balance what you eat with an appropriate amount of physical activity. Coca-Cola offers a range of high-quality beverages so that people can make the choices that are right for them. Obesity is a very serious problem, but trying to demonize particular foods or beverages is wrong and ultimately unproductive.

Clyde C. Tuggle
Senior Vice-President
Worldwide Public Affairs
Coca-Cola Co.
Atlanta

Editor's note: The study cited referred to earnings before interest and taxes from "less good" foods that could leave a company open to charges of contributing to obesity. The study was not specifically limited to foods with high fat content.

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Books

MOUNTAINS BEYOND MOUNTAINS

The Quest of Dr. Paul Farmer, a Man Who Would Cure the World

By Tracy Kidder

Random House • 317pp • \$29.95

AN ALTRUIST WITHOUT BORDERS

America tends to see itself as a generous nation, and certainly most of its citizens donate at least some of their money or energy to charity. But realists may question anyone who sacrifices too much comfort, time, or financial stability. You can't save the world, they say, and you'll only get frustrated trying.

Then there is Dr. Paul Farmer, a person who has made a huge difference in the lives of thousands of the world's poorest citizens—primarily because he believes that he can. Farmer is the subject of *Mountains Beyond Mountains*, the latest book by Pulitzer Prize-winning author Tracy Kidder. It is an engrossing and many-layered account of a man who, says Kidder, "seems to be living, as nearly as any human can, without hypocrisy."

Farmer's story is both compelling and disturbing. This brilliant, charming, and irreverent doctor, a professor at Harvard Medical School, has saved the lives of hundreds of Haitians, changed the world's treatment regimen for drug-resistant tuberculosis, and inspired countless efforts to bring medical care to the least-developed nations. He is the founder of Partners in Health, a small but influential nonprofit in Boston that funds clinics in some of the world's poorest spots. The winner of a MacArthur "genius" grant in 1993, he is a renowned infectious-disease expert, yet still takes time to treat indigent AIDS patients in Boston. But don't call him a saint: Farmer enjoys practical jokes and expensive meals, dotes on his young daughter and anthropologist wife in Paris, and can belt back vodka with the best of them at a Russian banquet.

So why is this well-written book disturbing? Because it's impossible to keep at arm's length. If you have an altruistic bone in your body, by the time you reach the end you'll be questioning why you aren't doing more to help others.

The book is not preachy, but Farmer "taps into a fundamental place in some troubled consciences...the often unacknowledged uneasiness that some of the fortunate feel about their place in the world," writes Kidder. "So we got da goin' for us," as Farmer would say—quoting, of all things, a line from the movie *Caddyshack*.

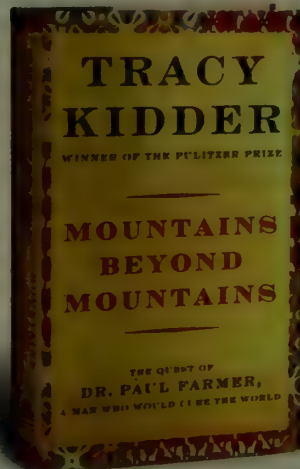
This is an unusual book for Kidder, best known for his detailed, entertaining examinations of much smaller subjects.

The Soul of a New Machine depicted the creation of one of the first mini-computers. *Among Schoolchildren* recounted a year in the life of a fourth-grade class in western Massachusetts. *Mountains Beyond Mountains* is far more wide-reaching: In one month described in the book, Kidder and Farmer traveled to Haiti, Peru, France, Massachusetts, Cuba, and Siberia.

Kidder for the first time also inserts himself into his

own book, standing in for the reader as he puzzles out loud about what makes Farmer run. "I imagine that many people would like to construct a life like Farmer's, to wake up knowing what they ought to do and feeling that they were doing it," writes Kidder. "But I can't think that many would willingly take on the difficulties."

Certainly Farmer is a hard act to emulate. Born in 1960, he is the second of six children raised by iconoclastic parents who lived in a converted school bus and ramshackle boat on Florida's Gulf Coast. The father, a public school teacher, expected a lot of his children and raised them to be both self-sufficient and open-minded. Farmer grew up with no running water, picked fruit in the summer with migrant workers yet still managed to graduate as valedictorian of his high school class, with a full scholarship to Duke University. There, he became interested in liberation theology, a branch of Catholicism



Dr. Farmer has saved the lives of hundreds of Haitians and worked to bring better medical care to poor nations

hat considers oppression of the poor to be a sin. In North Carolina, he also met a number of Haitian migrant workers and realized that their wretched living conditions made his own childhood look idyllic. He graduated from college having a fascination with all things Haitian and traveled to Port-au-Prince in 1983 with a determination to help.

This resolve was more than challenged by the conditions he discovered in Cange, the poorest part of one of the poorest countries in the world. The dusty land offered little sustenance, most of the populace lived in dirt-floor huts, disease was rampant, and there were no medical services to speak of. It was there that Farmer took to heart the old Haitian saying that gives this book its name: "After mountains there are mountains." Each problem leads to another problem, and you solve them one at a time. To Farmer, the first mountain was the need for a clinic in Cange, and he entered Harvard Medical

School in 1984 determined to start one.

Farmer graduated in 1990 at the top of his class, simultaneously receiving an M.D. and a PhD in anthropology. He was able to achieve this even though he had spent most of the previous six years in Cange founding Zanmi Lasante, a clinic that has transformed health care in the area. And he still regularly hikes through remote sections of Cange to treat patients.

His influence, meanwhile, has spread far beyond Haiti. He was instrumental in the mid-1990s in convincing the world's health organizations that multidrug-resistant tuberculosis, a deadly version of TB, could be cured. Back then, many experts thought it was pointless to treat drug-resistant TB in poor countries—the drugs were too expensive, and the regimen too hard to follow. But Farmer came up with an effective combination of drugs and spent more than a year persuading the World Health Organization to make the necessary medi-

cines affordable for use in poor nations.

Mountains Beyond Mountains is more than a recitation of one man's good deeds. It relates the stories of one desperately ill patient after another and shows how clean water, shelter, and decent nutrition can vastly improve their lot. The book also gives Farmer space to expound on the "hyperconnections" he sees between the massive accumulation of wealth in one part of the world and the abject misery in another.

Most of all, *Mountains Beyond Mountains* questions the complacency of the comfortable. Those are the people who, says Farmer, "think all the world's problems can be fixed without any cost to themselves." His example urges a different approach. After all, says Farmer, "there's a lot to be said for sacrifice, remorse, even pity. It's what separates us from roaches."

BY CATHERINE ARNST

Senior Writer Arnst covers science and health issues.

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4) Print



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BY STEPHEN H. WILDSTROM

tech&you@businessweek.com

PROJECTING THE RIGHT IMAGE ISN'T SO TOUGH



Portable projectors have shrunk in bulk and price. Some of them are even Wi-Fi enabled

In 1998, when I first wrote about portable projectors for use with laptops, the big news was that you could buy a "mobile" unit that weighed less than 10 lb. and cost about \$5,000. In retrospect, it seems as if you would have needed a projector really badly to put up with either the weight or the cost.

Like the laptops they work with, projectors have gotten dramatically smaller and cheaper, making them true mainstream products. The new \$2,699 LP120 from InFocus weighs less than 2 lb., and its distinctive long, narrow shape lets it fit in a briefcase along with a laptop. If your back is stronger but your budget weaker, you can get a bigger, but still portable, projector for less than \$1,000. And if you are tired of fussing with cables, some projectors let you connect wirelessly from a Wi-Fi equipped laptop.

Despite its diminutive size, the LP120 offers all the features a mobile executive needs in a projector. Its high resolution is valuable for projection of detailed spreadsheets or financial documents, and its lamp is bright enough for the image to be legible in a normally lit conference room, although dimming the lights will always improve the appearance. And it is very quiet.

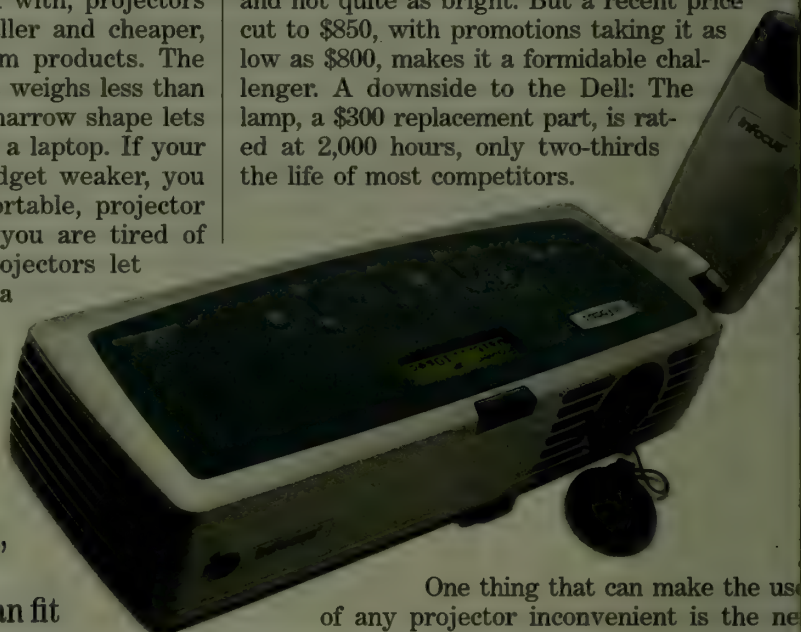
Some compromises had to be made to fit all this into a package just 10 in. wide, 3.7 in. deep, and 2 in. high. For starters, there are only two video inputs: a standard digital computer connector (most laptops only offer analog output and will need an adapter, which is included) and S-video for broadcast sources such as TV or DVD. There is a jack for audio input, but the sound quality is probably worse than your laptop's. And its lens provides only manual focus and zoom. Moreover, the zoom range is so limited that it's useful only for fine-tuning the size of the image after you have positioned the projector.

In the mobile tech world, you generally pay more for small. The extreme compactness of the LP120 requires a complex and expensive optical system. If you are willing to carry a somewhat heavier—2.2 lb. to 3.5 lb.—projector of more conventional dimensions, you have a number of

choices. These include the \$1,699 Hewlett Packard sb21, the \$1,895 NEC LT75Z, the \$1,700 Dell 3200 MP, and the \$2,199 InFocus LP70.

The more exciting news is the arrival of sub-\$1,000 projectors. Epson first broke the barrier this summer with its \$999 S1. At 7 lb. and bulk (10.4 in. by 14.6 in. by 4.2 in.), it's not something you would want to carry around every day. But it, and other projectors in its class, are a great value for the conference room or classroom and for occasional portable use. Toshiba quickly upped the ante with its \$999 TLP-S10 projector. This model and the Epson are a little bit brighter than the InFocus LP120 and offer lower resolution, but still good enough for most business uses. The Toshiba model weighs just 4.8 lb. and has about half the bulk of the Epson.

Now, Dell Computer is shaking up the market. Its 4 lb. 2100MP is a bit smaller than the Toshiba and not quite as bright. But a recent price cut to \$850, with promotions taking it as low as \$800, makes it a formidable challenger. A downside to the Dell: The lamp, a \$300 replacement part, is rated at 2,000 hours, only two-thirds the life of most competitors.



EASY TO TOTE
The long, narrow LP120 can fit in your briefcase—with a laptop

One thing that can make the use of any projector inconvenient is the necessity of tethering your laptop to the projector by means of a bulky cable that never seems to be quite long enough. Wireless solutions are coming to the rescue. Some projectors have Wi-Fi networking built in, but InFocus offers the LiteShow—a \$499 accessory that makes any InFocus projector with a standard digital video connector wireless.

I tried the LiteShow with the LP120 and ran into a couple of glitches. The projector would not power up with the LiteShow attached, so I had to put up with the minor inconvenience of plugging it in after turning the LP120 on. The wireless configuration is harder than it should be. You have to set up a mini-network for just the projector and the laptop rather than use an existing Wi-Fi network, and while this is not hard the instructions on how to do it are not clear enough. But once set up, the LiteShow worked beautifully.

These new projectors are easy to use, easy to transport, and easy on the wallet. Even if you don't spend the bulk of your working life giving presentations, a projector can be a valuable addition to your business tool kit.

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BY LAURA D'ANDREA TYSON

A NEW GOVERNOR WON'T FIX WHAT AILS CALIFORNIA



TOXIC BREW:

The recall shows that the mixture of money politics and direct-democracy provisions has made the state ungovernable

Laura D'Andrea Tyson is dean of London Business School. She served as dean of the Haas School of Business at the University of California at Berkeley from 1998-2001, where she has been a faculty member since 1978.

In the weeks remaining before California's historic gubernatorial recall vote, the media are focusing more on personalities than on issues. Voters are learning about Arnold Schwarzenegger's youthful escapades with sex, drugs, and body modification, about Arianna Huffington's revolving political principles, about Lieutenant Governor Cruz Bustamante's flirtation with Hispanic separatism, about Governor Davis' high school sports career. The focus on personalities is not surprising. California is the heart of the entertainment industry and America's celebrity-dominated political culture, and the characters in the recall are certainly colorful. Except perhaps for the one known as Gray.

But the recall election is about much more than personalities. It's about how the sixth-largest economy in the world addresses a massive budget crisis. And it's about whether California can be governed by anyone, regardless of personality. As a result of several progressive measures added to California's constitution nearly 100 years ago to protect citizens from manipulation by "moneyed interests," Californians can enact laws through voter initiatives, repeal laws through voter referendums, and recall their governor. Ironically, during the past 20 years, an exploding number of initiatives and referendums financed by private fortunes and serving special interests has usurped the intent of California's direct-democracy provisions. The campaign for a recall election, initially funded by a single wealthy conservative who aspired to be governor himself, is just the most recent manifestation.

So why have a large number of Californians expressed support for the recall? The state's budget crisis has fueled their discontent. State Republicans have blamed the crisis on the governor's out-of-control spending. But the facts reveal a far different picture. After adjusting for inflation, state per capita spending grew at an average annual rate of only 1% from fiscal 1989-90 to fiscal 2002-03, a much slower pace than during previous decades. Spending on K-12 education accounted for the largest share of the increase, reflecting two earlier voter initiatives—Proposition 13, passed in 1979, which halved local property taxes, the traditional source of K-12 funding, and Proposition 98, passed in 1988, requiring the state to dedicate 40% of its general funds to primary and secondary education to fill the gap. K-12 funding also grew in the 1990s in response to rapid growth in the size of the student population. Like other states, California also increased

spending on health and prisons. Together, education, health, and security constitute 90% of total state spending.

But California's budget crisis, like similar crises that have engulfed the other states, stems primarily from a steep drop in tax revenues resulting from the stock market collapse of 2000-01 and the national recession and jobless recovery of the past three years. Since California was the hub of the '90s technology bubble, its revenue base was hit especially hard. State revenues declined by about 17% in 2001-02—the largest slump in more than a half-century. Like most other states, California has a balanced-budget amendment that precludes borrowing to cover unanticipated revenue gaps. This left Governor Davis with no choice but politically unpopular spending cuts and tax increases to maintain budgetary balance.

Four out of five U.S. governors responded to this year's unprecedented budget crises by reducing spending and raising revenues. Over half of the governors proposed actual tax increases. Davis recommended a balanced combination of temporary spending cuts and tax increases. But after a long budget stalemate, Davis was unable to win legislative support for a single revenue-augmenting measure. And he alone among the 50 governors became the target of a vicious recall effort. Is the recall simply the result of the particulars of his budget proposal, his less-than-charismatic personality, or his lack of political courage? Of course not.

The recall demonstrates that the toxic brew of money's influence in politics and the direct-democracy provisions of California's constitution have rendered the state ungovernable. As a result of several voter initiatives, about 70% of state spending is earmarked in advance, limiting the discretion necessary to make trade-offs in a crisis. In addition, California is one of only two states mandating a two-thirds supermajority of both legislative bodies to pass a budget. Even in normal times in a state as vast and diverse as California, the supermajority constraint gives an ideological minority effective veto power. Finally, compulsory six-to-eight-year term limits for California legislators—the result of another voter initiative—further undermine the budgetary process. Many legislators simply do not understand budgetary trade-offs and can easily fall prey to lobbyists.

California doesn't need a recall election. It doesn't need a celebrity governor. It needs an economic rebound and a new constitution.

BY JAMES C. COOPER & KATHLEEN MADIGAN

CONSUMERS WILL KEEP CARRYING THE BALL

True, jobs aren't back. But tax cuts and refinancings are doing the trick

U.S. ECONOMY

The surprising deterioration of the labor markets in August would seem to throw a wrench into increasing expectations of strong economic growth in the second half. After all, consumers can't possibly keep leading this recovery without a pickup in job growth, can they?

Yes, they can in the short run. Despite last month's job losses, back-to-school sales and vehicle buying were strong, and September is looking busy for retailers, too. Consumers are reaping the benefits of tax cuts and low interest rates, policy moves that give households extra income. Plus, rising stock prices are adding to wealth. These positive trends provide a bridge for consumers to cross until demand gets another boost when businesses start hiring once more (page 36).



The spurt comes at an opportune time. Businesses are buying new equipment again, inventories need rebuilding, and the economy in general shows signs of renewed vigor. The Institute for Supply Management's business activity index for the nonmanufacturing sector has risen for five months in a row, with the August index at a high of 65.1%.

Also, factory orders rose 1.6% in July, while inventories fell 0.5%. The mix suggests factories will have to increase production to meet new demand. And the National Federation of Independent Business said its small-business optimism index jumped a record 4.1 points in August, to 104.7.

These upbeat reports suggest the economy in the second half could post the best back-to-back quarterly growth rates since early 2000. The strong performance underscores the notion that, with the right policy and accommodative financial conditions in place, consumers will keep shopping despite concerns over jobs.

OF COURSE, LABOR MARKETS MATTER. That's why the news of 93,000 more jobs lost in August was a head-turner. Economists had expected a small gain in jobs. Instead, the August decline brought the number of layoffs this year to 437,000.

All of the recent job losses have been in manufacturing (chart). Since the recovery began in November, 2001, factory payrolls have shrunk by 1.2 million,

while employment elsewhere has grown by 97,000.

Also, the dip in the unemployment rate, to 6.1% from July's 6.2%, was not a signal of labor-market improvement. The drop was caused by more people leaving the labor force. The percentage of the U.S. adult population working or looking for work stayed at 66.2%, the lowest participation rate in a decade.

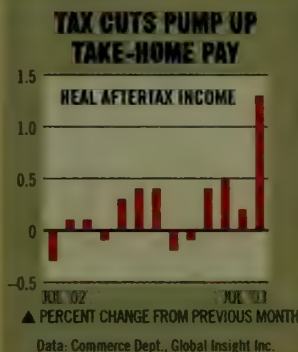
One bit of good news came from the continued advance in temporary-help positions. Businesses usually take on contingent workers until they feel confident enough to add permanent positions. And temp help has grown strongly for four months in a row.

Moreover, although the Labor Dept.'s survey of businesses shows continued layoffs, its survey of 60,000 households shows an increase of 868,000 jobs over the past year. About 140,000 of those jobs were in nonfarm industries, while 558,000 jobs reflected people listing themselves as self-employed.

It might be easy to dismiss the rise in self-employment as merely a way for some to deny their unemployed status. But the trend in proprietors' income—earnings derived mostly from privately owned businesses—supports the idea that this jobless recovery is pushing more people to become successful entrepreneurs. Nonfarm proprietors' income was up 9.1% in the year ended in July, a pace equal to the gains posted in the 1990s boom. These earnings, while 10% of all personal income, have accounted for nearly a quarter of the increase in overall income over the past year. Those gains partly explain why consumer demand is strong even while businesses are reluctant to hire.

THE TWO BIGGEST REASONS, though, are the July tax cuts and mortgage refinancings. The tax cuts, along with the child-credit rebate checks, should provide \$35 billion in extra cash in the second half. The boost can already be seen in the July data on personal income. Real income was flat, but aftertax pay jumped 1.3% (chart). That was the largest gain since the earlier Bush tax cuts were implemented in January, 2002.

Meanwhile, homeowners are improving their finances by refinancing their mortgages. When long-term in-



terest rates fell to 45-year lows in late spring, refi applications hit a record. As these loans close, millions of homeowners will lower their house payments or liquefy thousands of dollars of their homes' net equity.

Federal Reserve Chairman Alan Greenspan has focused on the boost that refinancings give to current spending. But the refi madness of the past year has come at a cost. For the first time in a decade, housing wealth fell in the second quarter. According to the latest Fed data, owners' net equity in real estate fell by \$45 billion, the biggest drop since the first quarter of 1993.

Back in the early 1990s, the drop was caused by a flattening-out in home values. This time, the decline can be traced to the growth in mortgages overwhelming the increase in home values. With refi activity slowing, housing equity should turn up in coming quarters. That suggests wealth should remain on the rise for the rest of the year, especially since balance sheets will also get a boost from the ongoing gains in the stock market.

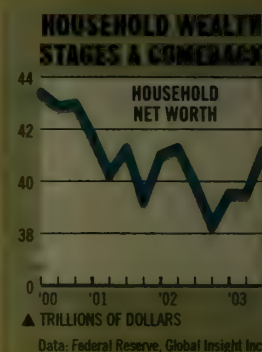
INDEED, THE STOCK MARKET RALLY was mainly responsible for last quarter's advance in household wealth. According to the Fed, net worth—personal assets minus liabilities—edged up by \$1.7 trillion in the second quarter from the first. Personal holdings of stocks and mutual funds increased by \$944 billion. Consumers also boosted the amount of money in their savings accounts.

After the bear stock market caused wealth to shrink

from 2000 to mid-2002, consumer balance sheets are on the mend (chart). At \$41.2 trillion in the second quarter, total household wealth is just 5% shy of equalling its record of 2000. If the equity gains continue and refis slow, net worth should overtake the old peak within the next year. That's another plus for future spending, since households tend to use a small percentage of their long-held wealth to finance current outlays.

Taken together, the latest data on wealth, refinancings, and tax cuts mean consumers will increase their purchases throughout the second half. But those supports can last only so long. By early 2004, the lift from tax cuts will peter out, and cashouts from refinancings will be much lower.

As any economist can tell you, job and wage growth are the prime movers of consumer spending in the long run. Businesses must start hiring if the economy is to maintain its new momentum. Nascent signs, from the rise in temp jobs to the surprise strength in demand, suggest that help-wanted signs will soon be appearing in greater numbers. That's good news for the 2004 outlook—and for the millions of job-seekers around the country.



BRAZIL

ONE GROWTH OBSTACLE AFTER ANOTHER

After just eight months in office, President Luiz Inácio Lula da Silva of the left-wing Workers' Party has won congressional approval for economically critical and politically controversial pension and tax reforms, which the last administration failed to obtain in its eight-year tenure. Now, da Silva faces a bigger challenge: reviving Brazil's economy.

In 2003's first half, Brazil's economy fell into recession. Most economists expect growth for the entire year to be a miserly 1%. And a government-linked research group recently embarrassed ministers by predicting growth of just 0.5% in 2003.

Business and labor groups have

been pressing for interest-rate cuts ever since the new government took office. But over the first half of this year, Brazil's central bank raised the overnight rate in an effort to rein in inflation, which hit 17.2% in May. The higher borrowing costs suffocated consumption and investment.

Inflation is now slowing—down to a 15% yearly pace in August—and is expected to keep falling. In response, the central bank has cut

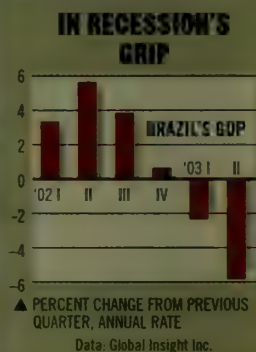
rates from 26.5% in June to 22%. Two more points could go at the next monetary committee meeting on Sept. 17.

However, costs to borrowers in Brazil remain stubbornly high, of-

ten more than 100% a year. More worrisome is the recent erosion in Brazilians' spending power. Workers' income fell by an alarming 16.4% in the year ended in July, according to government figures. Even if rates keep falling, consumers aren't likely to heat up the economy anytime soon.

Taxes are another obstacle to growth. Brazil's tax burden is among the highest in the world, equal to 41.7% of salaries. Reforms now proceeding through Congress will simplify the tax system, but won't reduce the total burden. That will be possible only if interest rates fall further and the government can keep spending in check, thereby reducing the amount of money needed to pay its own debts. For now, Brazil's economy is going nowhere.

By Jonathan Wheatley in São Paulo



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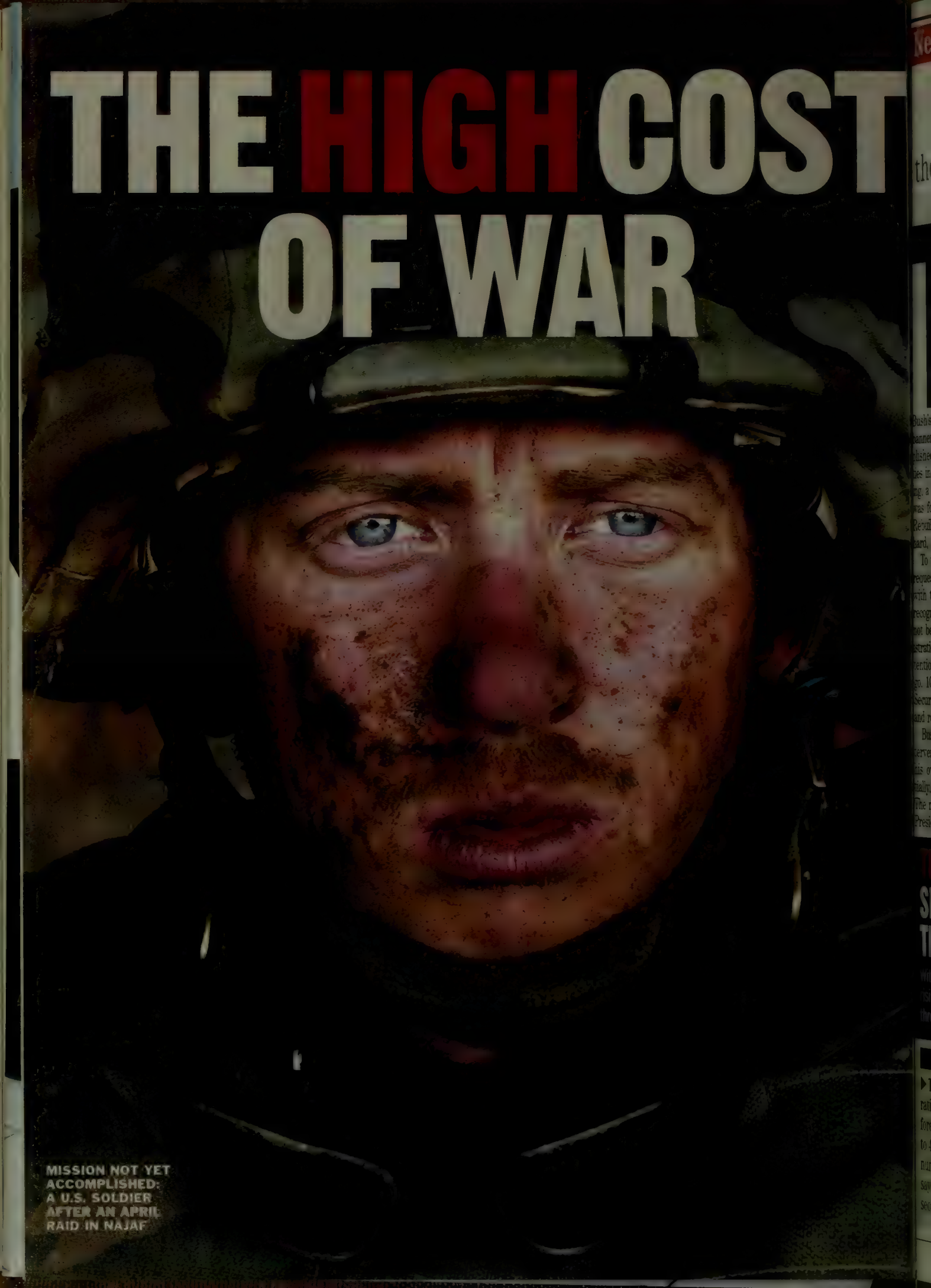
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The billions needed for Iraq could exact a toll on the still-fragile economy—and on Bush's political fortunes

The somber George W. Bush who faced TV cameras on Sept. 7 was a far cry from the jaunty leader in a pilot's jumpsuit who declared victory over Saddam Hussein just four months earlier on the deck of a U.S. aircraft carrier. Back then, Bush's victory speech was met with a banner that declared: "Mission accomplished." Now, with American casualties in Iraq mounting and chaos spreading, a President known for his optimism was forced to make a grim concession: Rebuilding war-torn Iraq would be long, hard, and costly.

To underscore the new reality, Bush requested a colossal \$87 billion. Along with the big price tag came a belated recognition that a strapped U.S. could not bear the burdens alone. An Administration long suspicious of the U.N.'s intentions in Iraq was now prepared to go, 10-gallon hat in hand, back to the Security Council to seek U.N. troops and reconstruction money.

Bush had little choice. The costs of intervention are beginning to mount—for his own political fortunes and, potentially, for a still-fragile U.S. economy. The number of Americans who say the President deserves reelection is at an

all-time low of 40%, and his party's once-huge lead on foreign policy has dwindled. Meanwhile, without substantial international help, the occupation's cost could send the U.S. budget deficit spiraling past \$500 billion in 2004 and threaten GOP plans for future tax cuts. If the red ink persists, rising interest rates could jeopardize future growth.

The depth of the problem became clear on Sept. 7, when the President asked Congress for \$87 billion, including \$51 billion for military operations in Iraq and \$11 billion for Afghanistan. Reconstruction would get an additional \$20 billion. That amounts to an 11% hike in discretionary spending. Federal spending next year would be nearly 20.5% of U.S. gross domestic product, the highest in a decade, while tax revenues will fall to barely 16%, the lowest level in 50 years. Says Robert L. Bixby, executive director of the Concord Coalition, a budget-watchdog group: "The Administration is pursuing a big-government agenda but is unwilling to pay for it."

Indeed, investors are growing wary of deficits nearing 5% of GDP. While interest rates have not yet reacted, "the markets are getting more concerned," says Banc of America Securities' strategist Gerald B. Lucas.

Of course, if the U.S. can extricate itself from Iraq quickly, the fiscal fallout would be limited. The bond market is

not likely to drive up rates much to finance a temporary expense—especially when there is little private demand for capital. But if the U.S. is still stuck in Iraq as the economy takes off, and companies start competing with the Treasury for cash, the crunch would drive up rates and could undermine the recovery.

While it is impossible to know how long the U.S. mission will last, defense experts have several scenarios—from expensive to wildly expensive. The U.S. now has 180,000 troops in and around Iraq, according to the Congressional Budget Office. The CBO estimates that 67,000 troops would cost \$14 billion annually. Steven M. Kosiak, director of budget studies at the Center for Strategic & Budgetary Assessments, projects the five-year cost of a 90,000-strong occupation at \$105 billion. Bush's request "could just be the first of many installments," says Representative John M. Spratt Jr. (D-S.C.), top Democrat on the House Budget Committee.

The costs of rebuilding Iraq are even more uncertain. The White House concedes the tab might be \$75 billion, but Kosiak says it could top \$100 billion over five years. The Administration insists those extra costs would be picked up by U.S. allies and by the sale of Iraqi oil. But so far that hasn't happened—and it may never happen.

Despite a prediction by Deputy De-

TROUBLE SPOTS FOR THE PRESIDENT

With costs and casualties rising, he's facing pressure on three key fronts:



POLITICS

- The President's approval rating for his handling of foreign policy has plunged to 40%, and with it the number of Americans who say that Bush deserves a second term.
- Bush's perceived vulnerability has prompted Democratic Presidential candidates to start attacking the President's competence in handling national security—normally a GOP strength.

ECONOMIC POLICY

- New Iraq funding will increase discretionary spending by over 11% in fiscal 2004, on top of a 4% jump for other government programs. Such hikes will make it harder for Congress to boost spending on popular domestic programs, such as education.
- Paying the Iraq tab also will limit the ability of Bush and the GOP to enact other tax cuts on the White House wish list, including breaks for business.

DIPLOMACY

- The Bush team is hoping other nations will lighten America's Iraq burden by sending money and troops to Baghdad. But some allies are demanding a greater political say for the U.N.
- As part of the effort to get allies to ante up, the U.S. transitional authority in Iraq may have to offer more contracts to foreign firms—contracts that so far have gone mostly to U.S. companies.

fense Secretary Paul D. Wolfowitz that Iraq could produce up to \$100 billion in oil revenues over the next two or three years, expectations have been sharply lowered because of sabotage and the decrepit state of Iraq's oil infrastructure. Now, White House aides figure the oil fields will generate just \$12 billion in '04 and \$20 billion each in '05 and in '06. But private analysts say the take is likely to be lower. An ongoing deployment of about 60,000 troops and an annual reconstruction bill of \$20 billion could saddle the U.S. with an annual Iraq tab of \$30 billion after 2004, even allowing for modest assistance from other nations.

Such costs add to an already soaring

deficit. Instead of the 10-year surplus of \$5.6 trillion that Washington anticipated two years ago, Goldman, Sachs & Co. now estimates the nation faces a \$5.5 trillion deficit in the decade 2004-13.

That means rough going for tax-cutters and big spenders. Republicans have a long list of new tax cuts, including new business tax breaks, efforts to make the '01 and '03 cuts permanent, and new incentives for savers and individual purchasers of health insurance. Business breaks, which included corporate rate cuts and investment incentives, were a top priority of many business lobbyists. Now, worries one, "there's just no way."

At the same time, bigger deficits

make it tougher for lawmakers to spend freely. A big highway bill, for example, will be delayed at least until next year, when backers hope the outlook will brighten. And a \$400 billion Medicare drug benefit also faces opposition from conservatives who question a new entitlement at a time of fiscal stress.

The Administration prefers another course: help from afar in the form of a new U.N. resolution that provides more peacekeepers and cash assistance to Iraq. Secretary of State Colin L. Powell predicts approval, a different outcome from the spring, when the Security Council rejected a U.S. pitch for help before the invasion. The difference, he told *BusinessWeek*: "We're not talking

COLIN POWELL: ON IRAQ, BUSH, AND HIS JOB

After interventions in Afghanistan and Iraq, U.S. combat troops are stretched thin and Washington's military options are growing limited. That means President Bush will be relying more in coming days on his Secretary of State, retired U.S. Army General Colin L. Powell, to steer foreign policy.

Powell has frequently tilted against Administration superhawks and now finds himself with an unenviable mission: extricating his boss from the seeming morass in Iraq by involving the same U.N. that the hard-liners once scorned—and the same allies who were offended by Bush's go-it-alone charge into Iraq's treacherous sands.

The Administration's shift toward more nuanced diplomacy is well under way—and marks another high point in Powell's up-and-down stint at Foggy Bottom. Powell & Co. are trying to drum up support for another U.N. resolution on Iraq. U.S. diplomats are in the midst of tough talks over North Korea's nuclear arms. The U.S. is orchestrating growing international pressure against Iran's nuclear program. And the deteriorating situation in the Middle East demands deft diplomacy.

On Sept. 9, the Secretary of State sat down with *BusinessWeek* Washington Bureau Chief Lee Walczak and Chief Diplomatic Correspondent Stan Crock and sounded a confident note in the face of some stiff foreign policy challenges.

Many people view the President's decision to seek more U.N. help in Iraq as a major policy shift. You don't?

It's more evolutionary than a shift.... We had a Madrid conference coming up next month for donors. So it seemed appropriate to go for a more comprehensive resolution. And frankly, we were getting pressed on a number of fronts to internationalize [the Iraq effort] more. We were working in that direction, and then we had the [U.N. Baghdad headquarters] bombing on the 19th of August. That kind of said: "Let's get going with this."

What does the U.S. hope to gain from an expanded U.N. presence?

The most important thing we can get [is recognition that] the war is now behind us, [that] there's political support for reconstruction.... If you measure it in terms of troops, there's a limit to how many could be made available for peacekeeping. And it's not going to result in "we will match your \$87 billion supplemental request." But it will certainly make it easier for those nations with the wherewithal to contribute troops or to give money to do so.

Some war foes are gloating about the U.S.'s need to ask for the U.N.'s help at this point. Your reaction?

They'd better not gloat too soon. There are a lot of good things going on that simply don't get reported. [The



story is] not as good as a [bomb] going off under a Humvee. But up in the northern section, things are going swimmingly. In the south, the British have done a good job. The tough at the so-called triangle, and there are Iraqis who are destroying their own country. They're neither Baathists, dayeen, nor terrorists. They're people stealing copper. And as soon as we get the economy going... that will pass

Will we have to cut foreign companies out of some Iraqi reconstruction contracts as a condition of new aid?

There are going to be enough

about going to war. We're talking about going to peace."

Analysts agree a deal can be cut—with U.S. concessions. "The diplomatic process is now going in the right direction," says Karsten D. Voigt, a senior official in the German Foreign Ministry. While there is little dispute over U.S. control of military operations, the U.N. wants a political role in Iraq—and other countries want a share of reconstruction contracts, which have been an American preserve.

Washington has O.K.'d Security Council review of any blueprint for a political transition, but Europeans may press further by seeking a U.N.-approved civilian overseer. The White House insists that U.S. proconsul L. Paul Bremer III must stay in charge. America sees him as the last hope be-

tween them and complete chaos," says François Heisbourg, head of the Foundation for Strategic Research in Paris. "This could be a very sticky point."

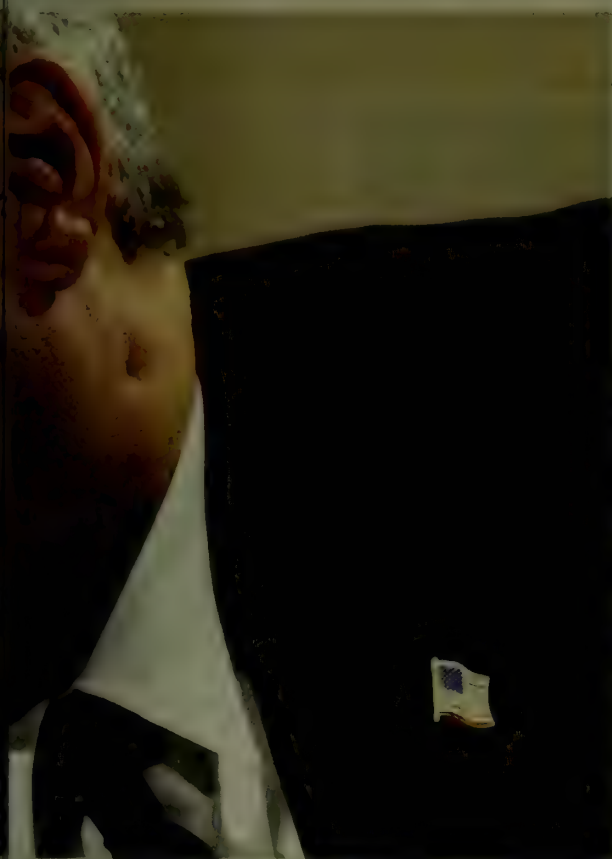
Even if a deal is reached, the Pentagon isn't counting on a lot of help from abroad. With few infantrymen available from Europe, the U.S. hopes to enlist Islamic nations such as Pakistan and Turkey, as well as India. And the cash contributions are likely to be just a few billion dollars—a fraction of the money collected for Desert Storm.

There's no question that the deteriorating Iraq situation is starting to damage President Bush at home. A Sept. 3-5 Zogby Poll found just 40% of Americans believe he deserves reelection—down from 49% in June. Continuing bloodshed in Iraq "has the capacity to make foreign policy a liability to Bush

rather than a great strength," says Columbia University historian Alan Brinkley. "The impact has been significant, but not irreparable."

By finally confronting the financial costs of the Iraq war, President Bush has taken a first step to repair the damage done to both the country's international prestige and his own political stature. He still has 14 months to stabilize Iraq before facing the voters, and a strengthening economy also could help restore his luster. But if the President and his advisers have learned one thing about Iraq since the war's end, it's that predictions are guesses at best and that more nasty surprises may lie ahead.

By Richard S. Dunham, Howard Gleckman, and Stan Crook in Washington, with John Rossant in Paris and Jack Ewing in Frankfurt



body in to replace Bremer?" Some say we need an immediate turnover [of power] to the Iraqis. I would love to have an immediate turnover. But the Iraqis aren't ready.

Our military is now stretched pretty thin. Has the use of force in Iraq made diplomacy easier in disputes with nations such as Iran and North Korea—by demonstrating U.S. resolve—or has it made it harder?

Obviously, the more places we're involved in, the fewer forces are available to go somewhere else. But the way the President sees it, he doesn't really have to think right now about a

thing if it can be avoided.... We haven't done a bad job in bringing Europe together [in support of U.S. policy on Iraq], but we still have a problem with the public because they have bought into this caricature [of the U.S.].

And the real picture is...?

Look at what the President actually has done. He's improved relations with China and Russia. We got the Balkan states added to NATO without causing Russia to go nuts. We got Russia added to the NATO family. This isn't the action of a swaggering bully.... The President speaks in a direct manner with a very direct approach that is refreshing but sometimes does not meet European standards of intellectual mumbling.

How does the caricature apply to you?

The caricature is that I'm in a constant battle with everybody. I'm either going to get fired next week or quit next week.... Sure, there's internal debate. And it's no secret that my views

“Some say we need an immediate turnover [of power] to the Iraqis. I would love to have an immediate turnover. But the Iraqis aren't ready” — COLIN L. POWELL, Secretary of State

acts for any nation that is committed to this effort to get a piece of it.

about the idea of a U.N. proconsul to supervise Iraq from on honcho L. Paul Bremer? Are the ones who have paid the political, economic, and military price to... How can you imagine that we suddenly say: "Please send some-

military option in North Korea because he has good diplomatic options. There are diplomatic options with North Korea and diplomatic options with Iran.

Many Europeans are worried that, after Iraq, the U.S. could again use force against its foes. Idle fears?

A lot of this is overwrought. The same opinion-makers in Europe don't ever want to use force hardly for any-

tend to be more moderate than some of my colleagues. But the President knew that when he hired me. I always measure not the daily line, but who crosses the finish line. The fact of the matter is that the only one whose foreign policy counts, decision counts, and whose philosophy counts at the end of the day is the President. I feel quite satisfied with the advice that I and this department have given him. ■

COMMENTARY

By Bruce Nussbaum

IRAQ: HARD LESSONS AND HOW TO USE THEM

War enacts its own reality. President George W. Bush confronted that fact in his speech when he acknowledged that the American occupation of Iraq was not going according to plan. He admitted that the pacification and rebuilding of postwar Iraq was going to cost more, take longer, and require the help of the U.N. To Congress and the public at large, who were told that American troops would be welcomed with flowers, that Iraq's reconstruction would be paid for by Iraqi oil, and that most U.S. troops would be coming home very soon after victory, it was a sobering message.

The President is absolutely right in saying the U.S. must not retreat from the task of making Iraq into a stable, safe, and secular country. Weakness and failure will only embolden extremists. But to win the battle against terrorism now requires an honest dialogue about what went wrong and what should be done going forward. With terrorists pouring into Iraq, the Taliban resurgent in Afghanistan, and Osama bin Laden and Saddam Hussein still at large, the U.S. faces the task of making America safer with fewer old friends and more new enemies. The level of anti-Americanism around the world has never been higher.

The next six to nine months are crucial. Unless the U.S. floods Iraq with more troops to secure it and billions more dollars to rebuild it, the country could devolve into a killing ground for America, sapping its economic and military strength. But to prevail, the country has to understand the lessons learned since the invasion. Here are some of them.

■ **A foreign policy of unilateralism didn't work, even for a superpower such as the U.S.** The failure of diplomacy with Turkey hurt the postwar military effort by preventing the Pentagon from sending troops quickly from the north into

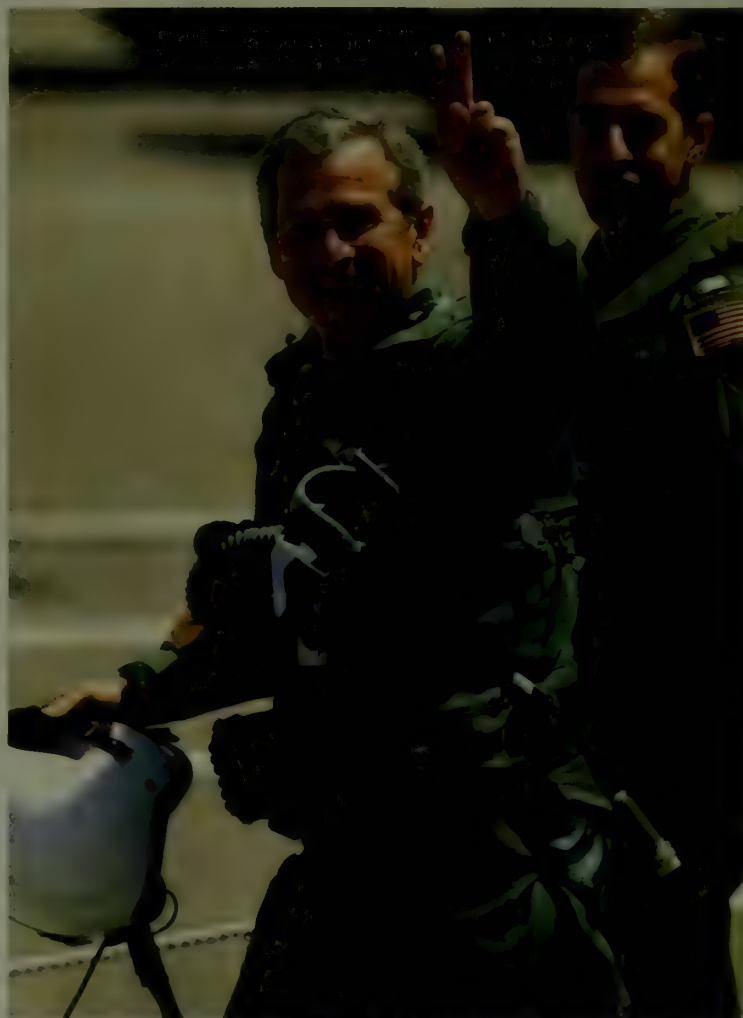
the Sunni/Saddam heartland of Iraq. That helped Saddam to remain free, regroup his Baathist ranks, attract outside terrorists, and kill U.S. troops. France certainly made it difficult for the U.S. to win a Security Council vote for regime change in Iraq. Yet the U.S. was unable even to get old friends such as Mexico, Chile, Turkey, or Germany to support it. China and Russia refused as well. The decision to invade without the U.N. mandate is now undermining the effort to enlist India, France, Turkey, and Pakistan to send tens of thousands of soldiers to reinforce and relieve U.S.

troops. They still insist on a multilateral U.N. umbrella.

■ **The doctrine of preemption was discredited by an enormous failure of intelligence.** Weapons of mass destruction have yet to be found, although both the Clinton and Bush Administrations believed they were there. No evidence of Saddam being behind September 11 has surfaced, even though polls show that most Americans believe he was. In the aftermath of September 11, the U.S. embarked on a new foreign policy of preemption. It meant invading countries even if they posed only a credible threat to the U.S., not an actual, imminent one. It was war by choice and required excellent intelligence to work. That intelligence was lacking in the decision to wage war in Iraq. The burden of proof will be much heavier for future conflicts.

■ **The Rumsfeld military doctrine lost credibility.** The theory of transforming the U.S. military into a smaller, more mobile, and more technologically lethal force appears deficient in Iraq. Dur-

ing the war itself, a larger invading force might have subdued Saddam's areas of support before they had time to organize. Postwar, a much larger occupation force than is currently on the ground is needed to provide security. How you win the war and how you police the peace afterward are as important as winning. Indeed, there is a danger of



TOP GUN: Winning the peace is tougher than winning the war

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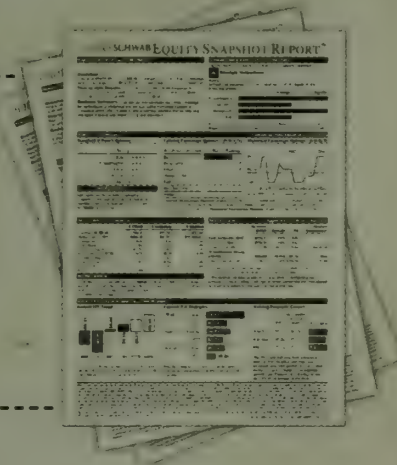
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reading too much into the Iraq victory, which is being publicized by military "transformationalists" as proof of their doctrine. There was no test of it. Saddam's army didn't fight, instead dissolving in the face of U.S. forces to regroup as guerrillas. Battling guerrillas takes more troops, not fewer of them. Yet when then-U.S. Army Chief of Staff Eric Shinseki testified that it would take 250,000 to 500,000 troops to secure Iraq based on experience in Bosnia and Kosovo, he was quickly rebuked by Deputy Defense Secretary Paul D. Wolfowitz.

The truth is that U.S. can't sustain the troops it has in Iraq. A Congressional Budget Office report said that the U.S. may have to cut its 140,000 troops there in half by the spring if the country is to remain prepared for conflict in North Korea. The commanders on the ground in Iraq understand that. They recently took the unusual step of bypassing Defense Secretary Donald Rumsfeld to join with Secretary of State (and former chairman of the Joint Chiefs of Staff) Colin Powell in asking President Bush to go back to the U.N. for a new mandate that would get foreign troops into Iraq. It's clear the U.S. military wants a multilateral occupation.

■ **The cost of the war to American taxpayers was vastly underestimated.** Pentagon officials assumed that a quick victory by "decapitating" the army and the Baathist bureaucracy would leave a functioning society in place. They planned for refugees, but not for looting. And they said Iraq's huge oil reserves would pay for nearly everything.

Facing a different reality, President Bush has called for \$87 billion in emergency spending for Iraq and Afghanistan next year, a sum more than twice what Washington spends on K-12 education. And this is on top of \$79 billion previously approved by Congress. It appears that it is far cheaper to fight a multilateral war than a unilateral one. America's unilateral foreign policy means the U.S. must foot the entire bill in Iraq unless it can belatedly persuade Europe and Asia to share the burden. In the first Gulf War, U.S. taxpayers shouldered only 7.6% of the total cost. Continued expenditures on Iraq will contribute to huge budget deficits for years to come, threatening future tax cuts and domestic programs such as the Medicare drug entitlement and perhaps fueling higher interest rates. Already, the federal deficit is approaching 5% of gross domestic product.

■ **The domino effect of removing Saddam has not occurred.** Getting rid of him was supposed to clear the way for a new road map for peace between Israelis and Palestinians. It hasn't. It was supposed to scare North Korea into freezing its program of building nuclear weapons. It hasn't. It was supposed to curb terrorism in the region. It clearly has had the opposite effect: Before the war, Iraq was not a hotbed of terrorism. Postwar, it is. We created what we said we wanted to prevent.

What is to be done? Rebuilding Iraq is now all the more important. Short term, the U.S. must get a large number of foreign troops onto the streets of Baghdad fast. We don't have the time—or the desire—to increase our own army fast enough to do what is needed in Iraq. This irrefutable logic requires Washington to make a deal in the U.N. to share decision-making in Iraq with France, Russia, and oth-

er members of the Security Council. The job of policing the streets should be given to others while American troops under U.S. command battle terrorists and Saddam holdouts. A deal won't be easy. But it can be done. European companies will have to get a piece of the reconstruction pie. The U.S. worked with NATO and the U.N. in the first Gulf War, the Balkans, and Afghanistan. To stop Iraq from becoming another lawless magnet for terrorists, it must do so again.

Long term, the U.S., Europe, and Asia must shape a new post-Cold War consensus on foreign policy. The central questions of the day are: When does a state lose its sovereignty, and who decides when a country is committing actions that warrant intervention? President Bush is correct in saying that the rise of terrorism and the proliferation of weapons of mass destruction change the rules of the game. But what are the new rules? Richard Haass, director of policy planning at the State Dept. under Colin Powell from

March, 2001, to June, 2003, and now president of the Council on Foreign Relations, writes in the summer/fall 2003 issue of the *Georgetown Journal of International Affairs* that states should lose their sovereignty when they harbor terrorists, commit acts of terrorism themselves, or threaten global security. He doesn't believe "promoting political or economic reforms warrants armed intervention." With

what we now know about WMDs in Iraq, war would not have been warranted under Haass' code of preemption.

Under British Prime Minister Tony Blair's code, it would have. In a 1999 speech in Chicago, Blair said that preemption is legitimate to stop the proliferation of WMDs, the spread of terrorism, and genocide or ethnic cleansing. He also said preemption might be necessary to end brutal dictatorships and promote democratic values. However one decides, these criteria provide the basis for an international consensus for a new post-Cold War foreign policy.

There is also room for rebuilding the multilateral institutions to enforce that new foreign policy. President Bush has said for some time that the old security arrangements don't work in a world of terrorism and WMDs. NATO is already taking on new post-Cold War roles in the Balkans and Afghanistan. Now, U.N. Secretary General Kofi Annan is suggesting that the U.N. needs to be reformed, especially the Security Council. Expanding the council to include India, Japan, and Brazil and ending the single-member veto to allow majority voting would make the U.N. a far more credible and efficient multilateral organization. The U.N. has shed blood in Baghdad. It has become a target. This puts the multilateral institution on the same side as America in the global war against terrorism.

President Bush, who likes to make bold moves, should lead the way in reintegrating America into the fabric of the global community. He has shown leadership in bringing the Eastern European nations into NATO, expanding foreign aid, and boosting money for AIDS in Africa. His next task should be to take foreign policy away from the failed unilateralist ideologues in his Cabinet and return it to the internationalists. It may be the only way to save Iraq and reassert U.S. influence around the globe.

Nussbaum is editorial page editor.

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READY TO SAY 'HELP WANTED'?

Surging demand should spur a second-half spike in hiring

In almost every respect, recent news on the economy has been the best in years. So where are the jobs? The unexpected loss of 93,000 payroll slots in August, on top of the 49,000 drop in July, was a shocker, especially in an economy that is showing signs of picking up powerfully in the third quarter.

Take heart, though. The second half is shaping up to be a whole new ball game. The breadth of the good news—from strong back-to-school shopping to the rallying stock market to a long-awaited pickup in capital spending—indicates that the economy is set to motor into 2004. This sustained surge in overall demand is why businesses will have no choice but to hang out “Help Wanted” signs soon. “Recent strength suggests that August’s drop in payrolls will be much more than reversed by year’s end,” says John Lonski, chief economist at Moody’s Investors Service.

What’s changed? To date, the major drag on new hiring has been sluggish growth. Since the recession ended in late-2001, output has been rising at an annual rate of just 2.6%—too anemic to offset the jobs lost to efficiency gains, more outsourcing, and greater use of temps. But now, as the recovery broadens and reanimates still-dormant areas of the economy, growth in the second half is likely to hit 4% to 5%. That’s just the sort of spurt Corporate America needs to start hiring again.

It won’t become a jobs bonanza, though, at least not before yearend. This quarter, companies are still wringing every bit of productivity they can from their existing workforces. Many economists are expecting the second quarter’s stellar 6.8% productivity advance to be repeated in the third. These huge leaps will moderate, however, since efficiency always spikes up in the early stages of an upturn as companies start to hike output without hiring new workers. But once demand really takes off, companies have to bring on new staff.

In fact, productivity gains are key to the economy’s rejuvenation and more

jobs. Until recently, productivity growth has been blamed for the paradoxical mix of growth and job losses. Now, with growth accelerating smartly, productivity gains should help both output and employment grow. “The business sector’s efficiency drive is the cure for—not the cause of—the economy’s ills,” says John Lipskey, chief economist at J.P. Morgan Chase & Co.

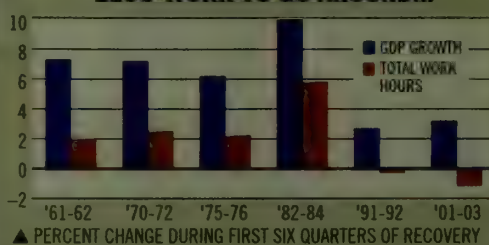
Here’s how the productivity payoff is starting to show for both businesses and their staff: Third-quarter profits are likely to be strong. If so, businesses will finally have both the funds and the inclination to invest in new gear, software, and buildings. Capital spending is growing even faster this quarter than the second quarter’s solid 8% pace, a three-year high. Given the historically tight correlation between capital outlays and hiring, the signs look clear that job growth will soon reappear. On the consumer side, productivity gains have helped businesses lift the pay of existing workers as personal incomes are boosted by tax cuts and the spare cash liberated by the slew of mortgage refinancings earlier this year. All this is driving up demand—which in turn leads to new jobs.

This chain reaction is beginning to become evident around the country. In New York, the Securities Industry Assn. thinks it’s possible for staffing by its members to grow 4% by yearend, regaining the record head count of 837,000



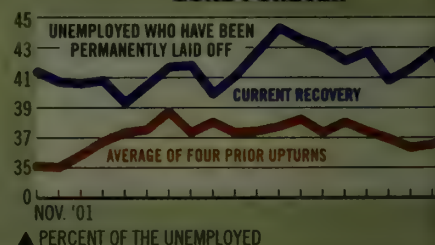
JOBS: THE BAD NEWS...

THE ECONOMY IS GROWING, BUT THERE'S LESS WORK TO GO AROUND...



Data: Labor Dept., National Federation of Independent Businesses, BusinessWeek

...AND MANY JOBS ARE GONE FOREVER





GRAND CENTRAL:
*The securities
biz is set to near
its 2000 head
count*

set in 2000. Medical-device maker Boston Scientific Corp. plans to add 1,400 new slots this year. And defense giant Raytheon Co. in

Lexington, Mass., expects to hire as many as 3,500 workers this year, up some 25% from last year's additions. And among small businesses, hiring intentions in August bounced up to the highest level in a year, says the National Federation of Independent Business.

Even executives in the long-stalled tech industry are beginning to look for new staff. "I'm optimistic about tech hiring and investment," says Michael Jordan, CEO of Electronic Data Systems Corp., the Plano (Tex.) information-technology services company. In Vernon Hills, Ill., computer reseller CDW Corp. recently announced that it will lift hiring 11% by adding 150 workers in the second half, and it's set to add more in 2004. Genentech Inc., the San Francisco-based biotech leader, has hired 1,090 people and is looking to add 200 more by yearend.

This represents a much different attitude for American businesses from that of a few months ago, but the enthusiasm is still spotty. "We expect pretty good growth," says Gene Hodges, president of Network Associates Inc. in Santa Clara, Calif., a maker of antivirus software. "But we have to hold expenses." And while temp employment—a reliable predictor of future full-time employment—has risen for four months in a row, Jeffrey Joerres, CEO of Milwaukee-based Manpower Inc., the nation's largest temp firm, says: "I'm more confident now than two months ago, but I'm still on guard."

Companies can afford to be cautious in the early stages of growth because it's easier than ever for them to grow without adding staff. Unlike labor mar-

kets just a decade or so ago, companies can boost output first by outsourcing or turning to temp workers or by pumping up productivity with new technology. Only when growth looks like a sure thing are they likely to add full-time, permanent staff. But with demand now getting stronger, some of that caution will begin to fade.

Of course, new jobs may not be coming back anytime soon in the hardest-hit corners of the economy. Some companies, especially in manufacturing, are still concentrating on cost-cutting rather than expansion. On Sept. 10, International Paper Co. in Stamford, Conn., said it will shed 3,000 workers, about 3% of its workforce, by the end of next year as part of its effort to save \$1.5 billion. The same day, privately held Levi Strauss & Co. announced that it will trim 650 jobs, or 5% of its 12,400-strong staff. And one-time highflier 3Com Corp., the Marlborough (Mass.) maker of

telecom and data gear, announced it will axe a third of its employees, or 1,000 workers.

Still, given how lean Corporate America has become, even struggling companies may be forced to hire, not fire, if they want to grow again. Troubled Qwest Communications International Inc. announced last

month that it's adding 500 more service reps in response to its dead-last ranking in customer service, as reported by J.D. Power & Associates Inc. And some manufacturers are finally seeing a long-awaited pick up in demand. In Joplin, Mo., Able Manufacturing & Assembly, a plastic- and metal-parts maker, has started hiring. As part of a new strategy, the company is doing more assembly work for its customers. CEO James Schwarz is so used to cutting jobs that adding workers feels strange. "It's kind of different," he says.

In its brief 18-month life, this recovery has been buffeted by all sorts of headwinds, from corporate scandals to war to volatile fuel prices. But the lack of jobs has been a constant bane. Now, that's set to change. All the important pieces—including stimulative government policy and accelerating demand—are finally in place to turn this jobless recovery into an upturn that creates more paychecks than pink slips.

By James C. Cooper and Kathleen Madigan in New York, with Robert Berner and Roger Crockett in Chicago, Faith Arner in Boston, Christopher Palmeri and Arlene Weintraub in Los Angeles, and bureau reports

Even executives in the long-stalled tech industry are starting to look for new staff

...AND SOME GOOD NEWS

SMALL BUSINESS SEEMS SET TO HIRE...



...AND SOME WORKERS ARE ALREADY IN DEMAND

HEALTH CARE	264,000
CONSTRUCTION & REAL ESTATE	188,000
RESTAURANTS & BARS	91,000
INSURANCE & BANKING	38,000
GENERAL MERCHANDISE STORES	38,000
PRIVATE EDUCATION SERVICES	20,000

JOBS CREATED DURING PAST YEAR



COMMENTARY

By David Welch

A SMALL REPRIEVE FOR DETROIT, BUT...

Detroit carmakers could certainly use a helping hand from the United Auto Workers (UAW) when the union's labor pacts expire on Sept. 14. After all, profits are mighty skimpy at GM, Ford, and Chrysler as they continue to lose market share to foreign rivals. True, the Big Three's primary problem is their inability to design hot new vehicles Americans prefer over Japanese ones. But they're also weighed down by massive labor cost disadvantages vs. foreign rivals—namely, the heavy cost of pensions and health care for 290,000 active workers and 370,000 retirees.

Anyone expecting Detroit to solve its labor problems in one swoop, though, will be disappointed. The UAW has made it clear that it won't swallow significant givebacks on benefits. So the industry will have to soldier on with these huge costs for years to come.

Still, the union is painfully aware of Detroit's situation and will likely offer some short-term aid and more over the long haul. It probably will accept lower wage hikes than it won in '99, insiders say. The UAW is also

likely to cede more leeway to cut jobs and sell plants, helping to slice costs and narrow the productivity gap with rivals. Most of the long-term workforce cuts Detroit needs will come over time, outside the framework of formal labor pacts, as the two sides together cope with Detroit's sliding market share. "The rank and file know that simply avoiding cuts in benefits and wages is a victory," says Sean P. McAlinden, a labor economist at the Center for Automotive Research in Ann Arbor, Mich.

What's Detroit likely to get? Ford Motor Co. will probably receive the union's blessing to close up to four plants, and Chrysler will be allowed to sell some parts plants, say company and union officials. In addition, the carmakers will now be able to use attrition to scale back the workforce. That's immensely useful, since nearly half of the UAW's Big Three

**OKLAHOMA
GM PLANT:**
*Reductions
by attrition
will help*

employees will be eligible to retire by 2008. Downsizing through attrition is slower than a sweeping restructuring, but it's enough to provide a powerful jolt to productivity.

Overall, the Big Three can cut about 50,000 jobs by 2007, or nearly 20% of their combined workforce, predicts McAlinden. Already, GM has boosted factory efficiency to 24 labor hours per vehicle—in striking range of Toyota Motor Corp.'s 23 and Honda Motor Co.'s 22. Detroit won't pass its rivals, but every gain helps pull down costs and offset its staggering retiree costs. The companies will make progress, but "these things tend to move slowly," says GM CEO G. Richard Wagoner Jr.

One example: Union leaders have looked the other way as GM has slashed its hourly workforce since 1999 by 21,465, or 17%, while hiring fewer than 5,000. That's a key reason why GM has inched closer to the Japanese on productivity. The cuts also more than offset wage hikes since 1999. Says Morgan Stanley analyst Stephen J. Girsky: "The key issue is minimum employment levels and how the union manages that."

Detroit's task will be even easier if the UAW accepts lower wage hikes. Four years ago, the union grabbed its piece of Detroit's soaring profits with 3% annual pay raises and 4% boosts to pensions. This time, management only wants to give wage hikes of 2% or so, insiders say. "It will be a weak agreement for the union," says McAlinden.

What the UAW won't budge on is benefits. There likely will be only minor concessions on health care, and GM, which has the most retirees, already knew it wouldn't get pension relief. Even before talks began, it borrowed \$14 billion to offset a \$19 billion shortfall in its pension fund.

The union isn't going to bail out the Big Three, though it has shown it will offer a helping hand. Now, Detroit must address Job One: coming up with great cars that consumers are dying to buy. Until that happens, the Big Three's slide is likely to continue.

Welch covers auto labor from Detroit.

THE GRAYING OF THE BIG THREE

HEALTH AND RETIREMENT COSTS PER VEHICLE*

\$1,360



GM

\$734



FORD

\$631



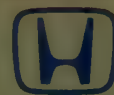
CHRYSLER

\$180



TOYOTA**

\$107



HONDA**

* Includes active and retired employees ** U.S. plants only
Data: Prudential Securities Inc.

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AIRLINES

STILL WAY BELOW CRUISING ALTITUDE

Even after a good summer, U.S. carriers are struggling

Continental Airlines Inc. was flying high as summer ended. With people cramming in one last trip before Labor Day, its planes were fuller than in any previous August, pushing up its unit revenues as much as 5%. Coming on top of July's 4.8% rise, that was Continental's best two-month showing since early 2001 and enough to put the airline in the black for the third quarter.

The summer returns for Continental and other major carriers offer hope that the airline industry may at last be pulling out of its nearly three-year slide. Thanks to cut-backs in their own payrolls and operations, as well as the unforeseen surge in late-summer travel, the big carriers should do better than many were predicting only a month ago. Already, airline stocks are heading higher, with American Airlines parent AMR Corp. up 35% and UAL Corp., the parent of bankrupt United Airlines, doubling in the penny-stock market in the past month.

Still, with summer crowds fading, the big question is whether full-fare business travelers will ever come back. Don't bet on it. Low-fare carriers have been steadily snaring corporate customers from the big airlines. Industry analysts have recently boosted their earnings forecasts for discount king Southwest Airlines Co. as well as up-and-comers JetBlue Airways Corp. and AirTran Airways.

The major carriers can't blame everything on low-fare competition, though. True, most businesses have lifted the restrictions that were imposed out of fear of terrorism, war, and SARS. But even with low-fare options and the economy picking up speed, many companies still aren't letting their employees fly

as they try to bolster the bottom line. "I think there's a new standard of frugality. And it's not going to change as companies become more profitable," says Alex V. Wasilov, president of travel agency Rosenbluth International.

That certainly seems to be the case so

lost almost \$20 billion. Although the third quarter is historically the industry's strongest, the top carriers are expected to lose up to \$800 million in the current quarter. In fact, industrywide profits won't pick up before 2004's second quarter. "We have to become profitable," says Douglas M. Steenland, president of Northwest Airlines Corp. "But as to when, we're not prepared to say."

Even newly profitable Continental sees little upturn in business travel. The number of trips flown by its 50 biggest corporate customers has fallen since 2001. Lawrence W. Kellner, the airline president, predicts business travel will not likely get back to its heights at the



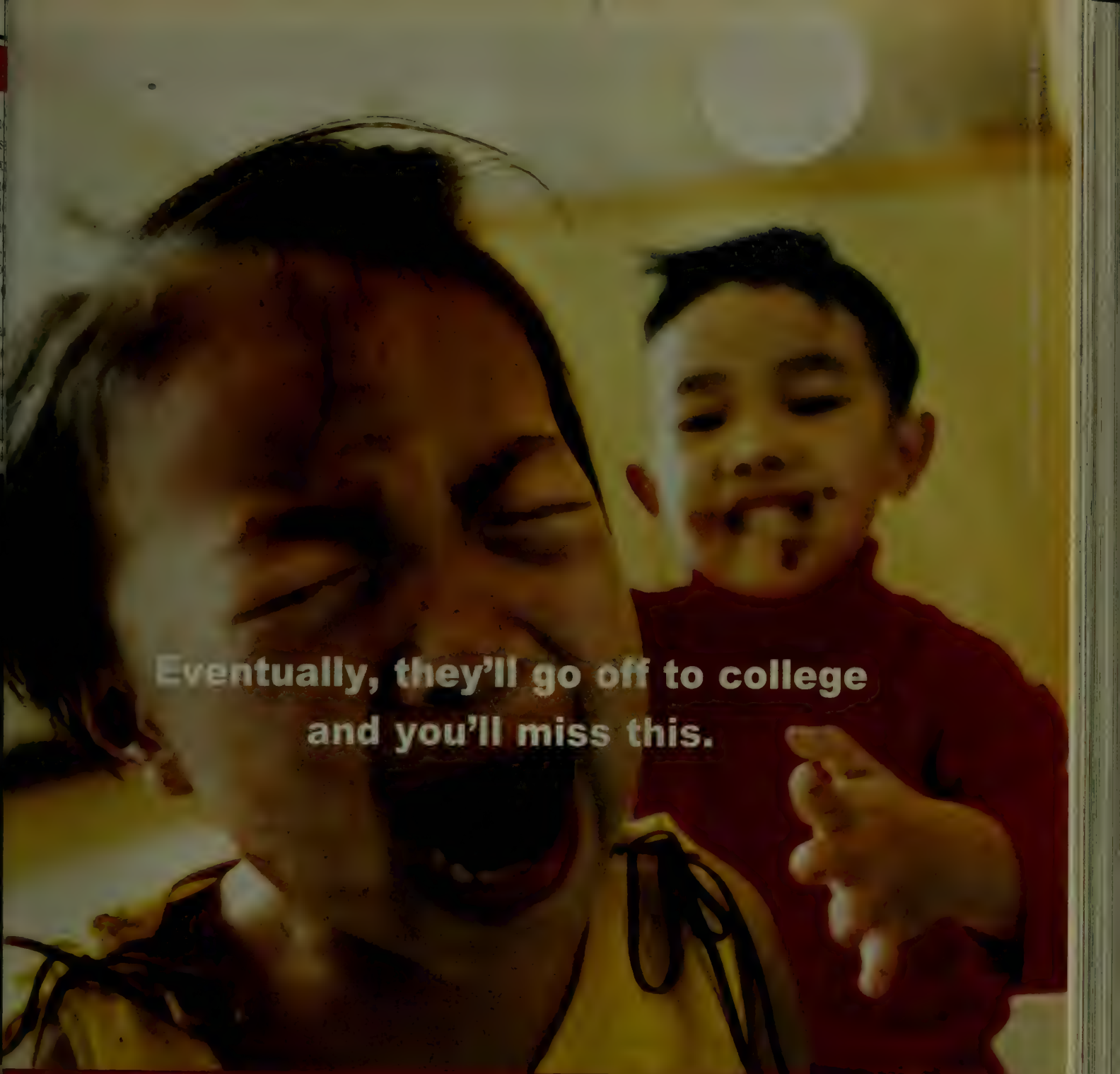
far. General Motors Corp. is holding its travel budget flat at 2002 levels by conducting more Webcasts and pushing people to drive on trips of less than four hours each way. Hewlett-Packard Co. still bars virtually all intra-company travel, while DaimlerChrysler's Chrysler Group is sticking with a two-year-old policy allowing only essential travel. Then there's PerkinElmer Inc. The \$1.5 billion health-sciences company has forgone big meetings and turned to Web travel sites to slash its annual travel budget to \$30 million from \$50 million in 2000, says travel director Thomas F. McCabe—all without disrupting business.

All that penny-pinching means a lasting headache for the airlines. Since 2000's third quarter, the industry's most recent profitable period, the top 10 have

turn of the century. Yet without more business travelers, he adds, the Houston airline cannot be consistently profitable. "The level of revenue activity we're seeing isn't going to drive a recovery," Kellner says.

To be sure, some companies are urging employees to get airborne again. Advertising and marketing execs at Interpublic Group are flying 10% to 15% more than they were a year ago. Business trips are also picking up at AstraZeneca PLC's U.S. subsidiary, says travel director Clive Armitage. "We've got new products coming to the marketplace," he says. "People need to travel. Too bad for the airlines that more companies don't share the attitude."

By Michael Arndt in Chicago, with Wendy Zellner in Dallas



**Eventually, they'll go off to college
and you'll miss this.**

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EDITED BY ANNE NEWMAN

AN EX-ENRON EXEC GOES UP THE RIVER

THE JUSTICE DEPT. LANDED A high-level conviction in its case against Enron, but the catch won't necessarily lead to bigger fish. Appearing in U.S. District Court in Houston on Sept. 10, former Enron Treasurer Ben Glisan Jr. pleaded guilty to federal conspiracy and will spend the next five years in prison. Glisan, 37, gave up nearly \$940,000 in ill-gotten profits, but he won't be testifying against former Enron Chairman Kenneth Lay, CEO Jeffrey Skilling, or even indicted CFO Andrew Fastow. Justice officials say Glisan refused to cooperate in their investigation of the energy trading company. Glisan admitted a role in arranging illegal transactions for two off-balance-sheet Enron partnerships in an effort to falsify the company's financial picture. His attorney did not return phone calls.

CLOSING BELL

DEBT-DEFYING ACT

Capital One Financial's credit-card customers must be feeling better—and now so are its shareholders. Charge-offs of bad debt fell sharply to 5.18% in August, down from 5.87% in July, the McLean (Va.) issuer of MasterCard and Visa said. The report sent Capital One's stock up 5.1% on Sept. 10.



A PAPERMAKER CHANGES THE GUARD

INTERNATIONAL PAPER SAID on Sept. 9 that President John Faraci, 53, will become chairman and CEO after John Dillon, 65, steps down next month. Faraci takes over as the Stamford (Conn.) paper and forest-products company copes with falling prices across the industry. On Sept. 10, the company said it's scaling back its workforce (page 37). While Dillon has hardly had a stellar record, International Paper has endured tough times under his watch, and analysts credit the 38-year veteran with streamlining the company through more than \$3 billion in asset sales.

TURNING UP THE HEAT ON GRASSO

THERE'S MORE TROUBLE FOR embattled New York Stock Exchange Chairman Richard Grasso, whose \$140 million payday has been widely condemned. The NYSE disclosed on Sept. 9 that he's entitled to an additional \$48 million that he'll forgo in an effort to defuse the controversy. The latest news is likely to crank up the pressure on Grasso. Normally pliant exchange members are going public with criticism, but Grasso still has support from his handpicked directors, who approved his lavish package in 1999. Grasso, who says he has no plans to resign, raked in \$87 million in pay and bonuses from 1995 to 2002.

NEW OVERSIGHT FOR FANNIE AND FREDDIE?

FANNIE MAE AND FREDDIE Mac are likely to get a new regulator now that Treasury Secretary John Snow has agreed to establish a Treasury bureau to oversee the housing-finance giants. The odds were boosted as well

HEADLINER: BILL JOY

OUT OF SUN'S ORBIT

Known as techdom's "other Bill"—and as revered in Silicon Valley as Gates is in Redmond, Wash.—Bill Joy's departure from Sun Microsystems on Sept. 9 is a symbolic blow to the beleaguered computer maker.

Joy single-handedly created the computer code that helped launch Sun in the early '80s. He championed efforts such as the Java language and other open-source technology, always stoking Sun's rep as a company on the leading edge.

But Joy's departure will have little impact. For years he has worked with a small team in Aspen,

Colo., and was rarely seen in Sun's Silicon Valley (Calif.) offices. Sun has little to show from his most recent efforts.

So why is he leaving now? "You should ask why I stayed so long," says Joy, who first thought about leaving in 1987. "I'm ready to take a break after 30 years."

Joy won't say what's next. But he's thinking about completing a book about the dangers posed by emerging technologies, such as nanotechnology and biotech, and even left open the possibility of starting his own company.

Peter Burrows



when Senate Banking Committee Chairman Richard Shelby (R-Ala.) agreed. Snow told a House panel on Sept. 10 that Congress should make the bureau stronger than the existing Office of Federal Housing Enterprise Oversight by allowing it to set capital standards, rather than follow those now mandated by law. He also wants Treasury to approve any new Fannie or Freddie ventures and suggested Congress end the President's right to name Fannie and Freddie board members. The Federal Home Loan Bank System, he said, also should come under the new regulatory umbrella.

SCHERING-PLOUGH SETTLES UP

SCHERING-PLOUGH CEO FRED Hassan has put one legal headache behind him. On Sept. 9, the drugmaker said it had settled an SEC probe

into whether Schering disclosed nonpublic information to big investors in meetings in 2002. Schering will pay \$1 million fine, while former CEO Richard Kogan will pay \$50,000. Under the pact Schering and Kogan did not admit or deny the charges. Kogan's attorney said Kogan did not buy or sell stock or profit from what took place at the meetings. Schering still faces other legal troubles, including a federal criminal probe into some of its marketing and pricing practices.

ET CETERA...

- An FDA panel recommended approval of Genentech's psoriasis drug, Raptiva.
- The Federal Communications Commission blessed a deal aimed at speeding adoption of high-definition TV sets.
- Microsoft warned of a new security hole in its Windows operating system software.

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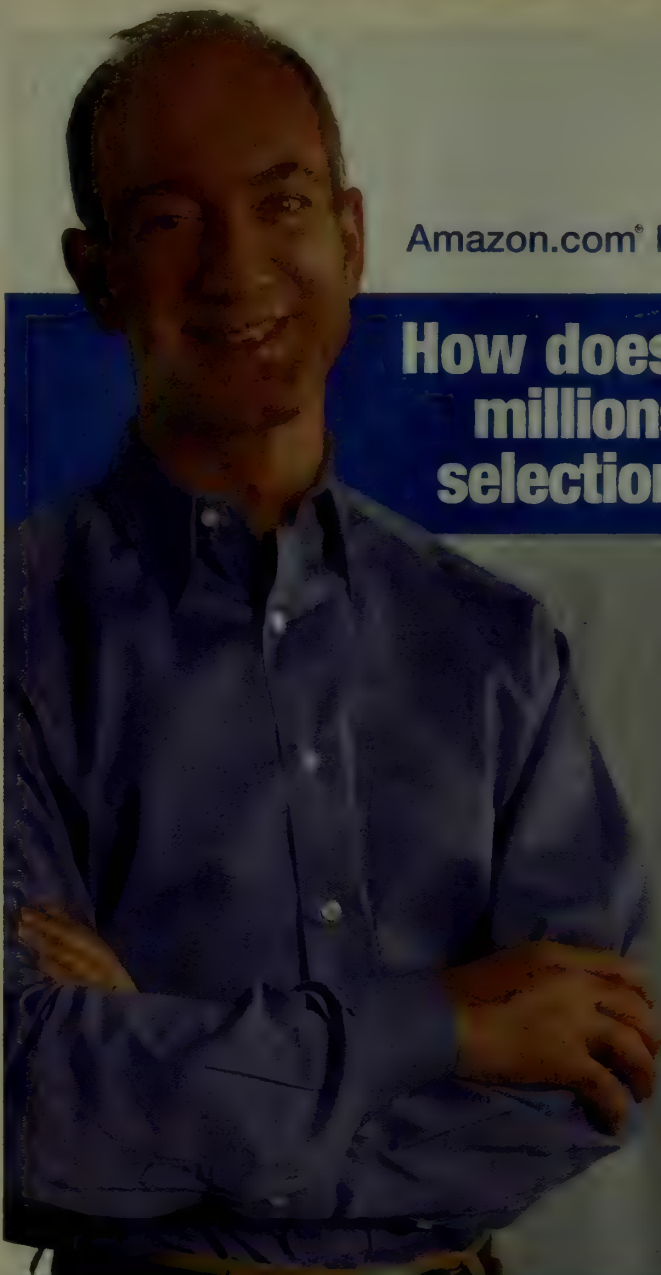
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The Power to Know.



EDITED BY MIKE McNAMEE

CAN HOWARD DEAN SWIM IN THE MAINSTREAM?

The Democratic Establishment has reacted to former Vermont Governor Howard Dean's surge to the top of the Democratic Presidential field with a combination of shock and awe. They're awed by the Washington outsider's incredible ability to build a grassroots organization and raise more funds than better-known rivals. The shock is their fear that Dean could lead the party to a catastrophic defeat in 2004, much like another antiwar insurgent, George S. McGovern.

Well aware of those tremors, Dean is scrambling to transform his campaign from an insurgency to the Democratic center. Privately, he's reaching out to party elders, from union heads to moderate mandarins like former Democratic National Committee Chairman Bob Strauss. Publicly, he's working to broaden his mostly white, hard-left coalition to bring in minorities, moderates, independents, and even pro-gun conservative Democrats.

But Dean, who's at the head of the pack in both New Hampshire and Iowa polls, could discover that his outreach efforts come at a steep cost. In wooing moderate leaders, Dean stresses his budget-balancing record in Vermont and his pro-gun stance—positions that might surprise some of the left-wing activists who have stoked the fires of the Dean candidacy. And opponents are quick to accuse him of flip-flopping on long-held positions on free trade, the Cuban embargo, and Social Security reform to win the backing of key voter blocs.

The greatest danger: Dean could lose his image as a tell-it-like-it-is outsider in the mold of maverick Republican John McCain. That's particularly risky with General Wesley K. Clark poised to challenge Dean for the anti-pol mantle (box). "You can't be considered the straight talker if you look as though you're pandering," warns retiring Representative Cal Dooley (D-Calif.). Dean's challenge is to portray his policy

changes as an open-minded reevaluation of national issues—not as politically inspired turnarounds.

Dean's personal diplomacy is already paying dividends. Such party stalwarts as Gerald W. McEntee, president of the American Federation of State, County, & Municipal Employees, have gotten a hard sell from the governor. Privately, some labor leaders are weighing Dean's argument that he's the most electable candidate. Dean is also bidding for support from minorities, who have been notably absent from his rallies. He's one of the first white candidates to start running spots on African-American radio stations.

But Dean is also making inroads on the party's right, impressing moderates such as Strauss and Representative Charles Stenholm (D-Tex.). "I said when McGovern became our party's nominee that he was too far to the left," recalls Strauss, who was chosen to clean up the mess after the Dems' 1972 debacle. "When you look at it issue by issue, I don't think that's the case with Dean."

On some of those issues, however, Dean could be courting trouble. His Democratic foes say the governor has backed away from talk about raising the Social Security retirement age—anathema to aging baby boomers—and has dropped his opposition to the embargo on Cuba, a vital issue in closely divided Florida. And while he supported NAFTA, he now sounds

more like a unionist fair trader, emphasizing the need to impose labor and environmental standards on trading partners.

Six months ago, as one of the longest of long shots in an overcrowded field, Dean's biggest challenge was just to get noticed. He has done that—in spades. Now he has to keep the base that he energized with his insurgent campaign while expanding his appeal to the Democratic mainstream. Coming from behind may be easier than staying in front.

By Alexandra Starr



DEAN: Reaching out

CAPITAL WRAPUP

READY FOR BATTLE

► One of the Democrats' longest-running guessing games may be resolved on Sept. 19, when retired General Wesley K. Clark appears at the University of Iowa College of Law. According to associates, the former NATO commander will toss his helmet into the ring, becoming the 10th Democratic Presidential aspirant in an over-stuffed field.

Skeptics say Clark's overreaching. He's a political novice, registering in the low single digits in polls, without

money or a field organization. "He's a smart, talented guy, but his organized support is limited," says independent New Hampshire pollster Richard Bennett.

But the Clark camp insists the field is still wide open. In polls, two-thirds of Democrats can't name any of the nine candidates. Fans say Clark, 59, appeals both as a military leader (à la Dwight D. Eisenhower) and a quirky outsider (à la H. Ross Perot). And Clark could be the Dems' most



LIKE IKE? Clark

credible critic of George W. Bush's Iraq troubles.

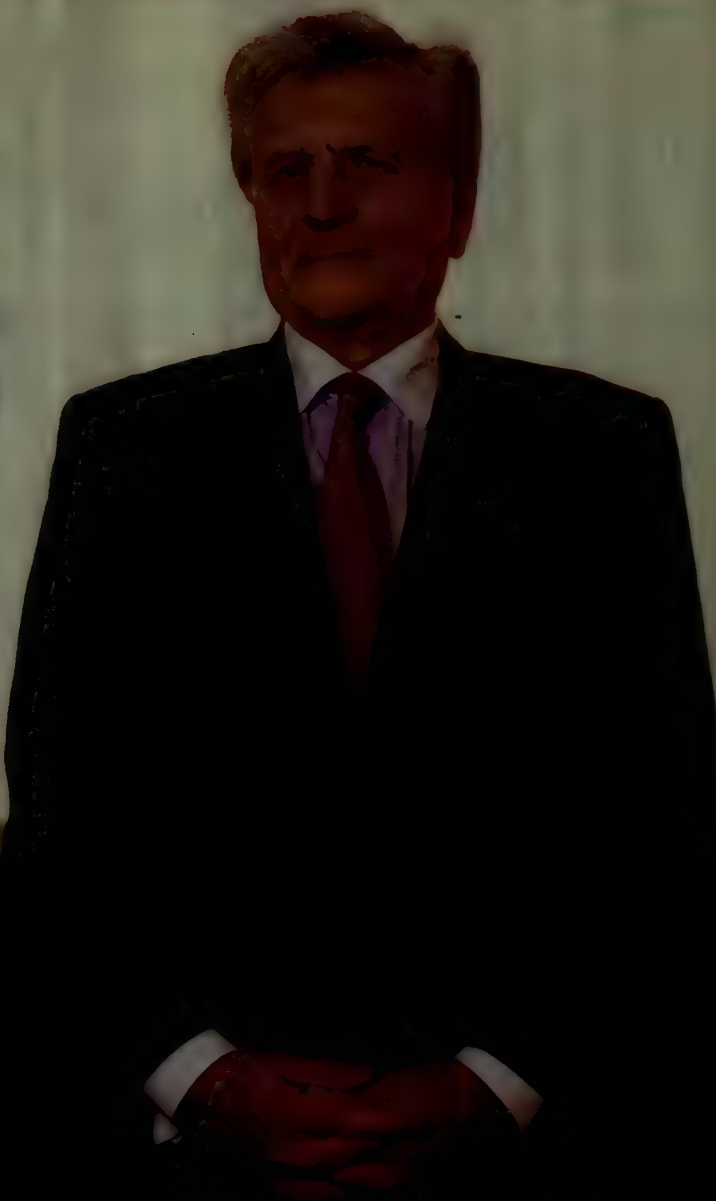
As for troops, Skip Rutherford, president of the Clinton Presidential Foundation, says a cadre of former Clintonites—including former White House Counsel Bruce Lindsey and Chief of Staff Thomas "Mack" McLarty—is ready to bivouac in Little

Rock. "The 'Friends of Bill' network is alive and well—and ready to become 'Warriors for Wes,'" Rutherford says.

By Lee Walczak

BANKING

THE ECB'S NEW BOSS



Is Jean-Claude Trichet the central banker Europe needs?

It's not the heavy antique desk or centuries-old, gilt-framed portraits visitors notice when they enter Jean-Claude Trichet's elegant first-floor office at the Banque de France, where he has served as governor since 1993. What immediately catches the eye is a brightly colored abstract painting—a prewar work by Hungarian-born, Paris School artist Emile Lahner—hanging behind Trichet's chair. “It represents moderni-

ty,” says the incoming head of the European Central Bank. “You sometimes need reminding of that in an institution that is more than 200 years old.”

Trichet says he may take the painting with him when he moves to Frankfurt in November to take charge of the five-year-old ECB. As president of the complex, multinational organization that sets interest rates for the 12 countries using the euro, he will need all the inspiration he can get. In his new job, he will oversee monetary policy for the world's second-largest economy, home to 305 million people, and will head the only institution with a mandate to set economic policy for the entire euro zone. Trichet notes that there is no European counterpart to the U.S. Treasury that sets and manages a euro zone budget. In other words, the ECB, in its unique power to shape Europe, is on its own.

Trichet is expected to give new clout and visibility to Europe's young central

bank. He will replace Wim Duisenberg, a towering, white-haired Dutchman known for his hawkish monetary policy and early in his term, glaring gaffes. The latter shouldn't be a problem for his successor, who is famous for his savoir faire. But will Trichet also make more substantive changes at the ECB, whose four-year-old euro has the potential to become a global reserve currency? Other central bankers, along with business executives, politicians, and pundits, have been trying to read the Trichet tea leaves ever since it became clear he would be exonerated in an investigation of his role in an old scandal involving

Five-Year Report Card On the European Central Bank

Data: BusinessWeek

Jean-Claude Trichet

BORN

Dec. 20, 1942, Lyons, France

EDUCATION

Ecole des Mines, 1964; Institut d'Etudes Politiques, 1966; Ecole Nationale d'Administration, 1969 to 1971

CAREER HIGHLIGHTS

1961 Spent three months mining coal at the Auchel mine in the Pas-de-Calais

1971 Joined Finance Ministry

1985 Named chairman of the Paris Club

1987 Appointed head of French Treasury

1993 Named governor of the Banque de France

2003 Cleared of wrongdoing in Crédit Lyonnais probe, setting the stage for his rise to president of the European Central Bank in November

FAMILY

Married for 38 years; two sons

Data: Banque de France, *BusinessWeek*

we have the largest central bank in the world after the Fed and one of the planet's greatest central bankers will now head it," says Daniel Bouton, chairman of Société Générale, the large French bank. "The whole weight of the ECB is going to be very seriously increased." Friends and admirers are certain he will bring a fresh style of management to the ECB. He has run France's central bank with aplomb. In that post he didn't shrink from driving interest rates sky-high to protect the franc, or from confronting powerful politicians he deemed too fond of public spending.

That toughness indicates to some observers that Trichet will be a much more activist ECB head than Duisenberg. They think he will try to convince his fellow ECB governors to spur growth and fight inflation with more aggressive interest-rate moves. They also think he will go beyond his strict mandate to ensure price stability and try to influence overall euro zone economic policy. A lifelong civil servant, he's known as much for his razor-sharp political instincts as for his polished diplomatic demeanor. "To have real power [at the ECB] you need to be persuasive and win people over," says Alexandre Lamfalussy, the former head of the Bank for International Settlements and also the European Monetary Institute, the precursor of the ECB. "And Trichet has shown that he has the ability to get ideas across." One area where observers think he may seek to make his mark early is pushing to raise the ECB's 2% ceiling on inflation tolerance to promote faster growth.

Trichet takes over at a particularly challenging time for the bank and the \$7.7 trillion euro zone economy. Euro

pe is underperforming, pulled down by sluggish growth in Germany, France, and Italy. The French and Germans are squabbling with other European Union ministers, who are irked that the euro zone's two largest economies are breaking the rules governing the size of their budget deficits. In addition, the ECB's mandate will soon expand dramatically, with 10 new nations scheduled to enter the EU in May. All of them are expected to seek admission to the 12-nation euro club within five years.

To address these issues, many think the ECB needs a hands-on, Alan Greenspan-type president. Over the past five years, Greenspan's Fed has clearly acted more aggressively than the ECB. While the Fed's benchmark rate peaked at 6.5% in May, 2000, and fell to 1% in June this year, ECB rates rose to 4.75% in October, 2000, falling to 2% in June, 2003. Critics of the affable Duisenberg, who likes the ECB to reach decisions by consensus, say his administration moved too slowly and timidly over the past two years to fend off recession.

Proponents of change want the ECB's new president to forge closer ties with EU finance ministers and encourage a more flexible, Federal Reserve-style approach to monetary policy that bases rate movements on growth as well as inflation. True, under the terms of the Maastricht Treaty, which paved the way for economic and monetary union in Europe and laid down the ground rules for the ECB, the bank's primary mandate is to ensure price stability. But there is some wiggle room: It's up to the ECB to define just what price stability encompasses. "The markets expect significant changes under Trichet," says Austin Hughes, chief economist at IIB Bank Ltd. in Dublin.

It's a testament to Trichet that the conservative French President Jacques Chirac and ex-socialist Prime Minister Lionel Jospin both backed his appointment to the presidency of the ECB in

THE ECB GETS HIGH MARKS FOR...

BIRTH Masterminded smooth introduction of currency in 1999 and Euro notes and coins in 2002

FIDES Established credibility in financial markets with accuracy, predictability, and respected policymaking calls

INFLATION SLAYING Enforced mandate to seek price stability by keeping inflation at or around a 2% ceiling

ENDING EAST Set clear rules for accommodating new members without slowing the decision-making process

...BUT STILL NEEDS TO MAKE IMPROVEMENTS IN

ECONOMIC GROWTH Must do more to stimulate the euro zone, where expected growth is stuck at 0.7% this year

EMERGENCY OVERSIGHT Needs to clarify responsibility for bank crises with EU's national central banks

POLICYMAKER PARTNERING Not enough coordination on monetary and fiscal policies with EU finance ministers

PUBLIC RELATIONS Must do a better job of communicating policies and goals to politicians and the general public

1998. But the top job went to Duisenberg, who was strongly supported by Germany, on the understanding that Duisenberg would step down to make way for Trichet before his eight-year term expired. Those plans were thrown into disarray in early 2000, when Trichet was implicated in an accounting scandal at formerly state-run *Crédit Lyonnais*. The bank had used accounting tricks to hide big losses, and Trichet, as head of the French Treasury in 1992, had signed off on the bank's accounts. In July, 2002, he was ordered to stand trial. His delicate legal status forced Duisenberg to stay on an extra year at the ECB's helm. But Trichet's ordeal ended on June 18, when he was acquitted of all charges.

Trichet has been a forceful administrator of the *Banque de France*. But that doesn't mean he can dominate the ECB, which, unlike the French central bank, grants its president no authority to override fellow members of its top policymaking body. "Perhaps there's an exaggerated sense of what one man can do," says Hughes. What makes the ECB unique among central banks is that it's a grouping of equals rather than a board run by a chief executive. Of its 18 governing council members, 12 are there as governors of the euro zone's national central banks; the other 6, including the president, are executive board members appointed by the EU Council, which is made up of heads of government. On the governing council, the chief of the Central Bank of Luxembourg has as much power as the governor of Germany's Bundesbank, and both are considered equal to the president.

Even Greenspan would be daunted by such a setup. The ECB president must cope with 12 countries, 9 languages, and myriad political and economic systems. There isn't much of a bully pulpit for the ECB chief, either. Duisenberg's quarterly testimony before the European Parliament was widely ignored by the European press—nothing like the media excitement that often follows Greenspan to Capitol Hill.

Still, Trichet's backers are convinced that this son of a literature professor is the man who can create public receptivity for much-needed reform in Europe. And he seems ready to accept the challenge. "We have a lot of homework to do," he says, "so that ordinary people understand the need for change." It's clear that Europeans will hear a great deal about economic reform from their new top banker.

By David Fairlamb, with John Rossant, in Paris



GERMANY

REVOLT OF THE YOUNG

Germans balk at the heavy cost of supporting retirees

It wasn't the sort of political discourse Germans are used to. Philipp Missfelder, chairman of the youth wing of the center-right Christian Democrats, griped that medical care for old folks was creating an intolerable financial burden for the young. It's about time 85-year-olds started paying for their own hip replacements and false teeth, Missfelder declared in an August interview with the Berlin daily *Tagesspiegel*. "In the old days, people got around on crutches," he said.

In consensus-oriented Germany, Missfelder's comments provoked a furious backlash. Within days, Christian Democrat elders had muzzled the 24-year-old politician. Yet it's dawning on Germany's young people that the retirement years won't be nearly so comfortable for them as for their elders. Nowadays, Grandpa and Grandma typically retire by 60 and, if they've paid into the system their whole working lives, may together collect a government pension of more than \$45,000 a year. But nowadays, 30-year-olds

GOOD YEARS: Now, state pensions can hit \$45,000 annually

may have to work until 70—and wind up collecting a lot less. Meanwhile, their payroll deductions largely support today's old folks. "I have long given up any expectation of receiving a dime from the government when I'm 60," says Arndt Rautenberg, the 36-year-old managing director of the Ger-

man unit of software consultant Sapient. *Stern* magazine featured the aging debate on its Sept. 4 cover, which describes a future where soaring payroll deductions for social security drive even more companies and workers to other shores.

Chancellor Gerhard Schröder's main response has been to name a high-profile panel. The group's recommendations, issued on Aug. 28, include pushing the retirement age from 65 to 67 starting in 2011 and reducing benefits in line with declines in the number of people who pay into the pension system. But Schröder was noncommittal, promising only that he would "thoroughly examine" the proposals.

Political foot-dragging irks young folks already frustrated by red tape and labor regulations that make it hard to start a business or just get a job. Schröder's harshest critics even include his party's youth wing, the Young Socialists, or Jusos. They accuse Schröder of spineless, orienting policy according to headlines in the tabloid *Bild*, Germany's biggest newspaper. Germany's labor law "above all protect those who are already in a completely insured eight-hour-a-day job," complains Björn Böhning, deputy chairman of the Jusos. True. But considering the German record on reform so far, young folks should probably start saving up for that hip replacement.

By Jack Ewing in Frankfurt

The Graying Of Germany

Percent of total population

PEOPLE AGE 20-60*	PEOPLE 60 AND OVER
2001	2001
55%	24.1%
2010	2010
55.7	25.6
2020	2020
53.3	29.2
2030	2030
48.5	34.4
2040	2040
48.4	35.2
2050	2050
47.2	36.7

*Current average retirement age in Germany
Data: Federal Statistics Bureau



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AFGHANISTAN

OPERATION: STABILITY

Can Afghans create enough civic order for free elections?

In dusty, desolate Kandahar, the roads are rubble and the buildings are ruins of brick and mud. The city, once the stronghold of the Taliban, looks as though it died when the regime deserted it after the U.S. bombing in October, 2001. There are few signs of life: An occasional pickup truck drives by with armed men in the back. In the unusually quiet bazaar, merchants sell fruit from handcarts or cheap Chinese electronic gadgets in tiny shops. Women rarely venture out, and when they do, fear still compels them to cover themselves from head to toe with burqas.

But away from the city center in a heavily guarded building that serves as

the headquarters of an organization called Afghans for Civil Society, a more hopeful scene unfolded in early September. There, 31 Afghan women activists—some illiterate, others educated—shed their burqas and animatedly discussed Afghanistan's new constitution, expected to be made public in late September by Hamid Karzai, president of Afghanistan's transitional government. The women are hoping that the document, which is supposed to set the stage for national elections in June, 2004, will include equal rights for women in divorce, inheritance, and voting, as well as mandatory education for girls.

These are exciting, radical, almost seditious ideas in this conservative coun-

PROGRESS

Kabul is seeing construction such as this school, but other areas aren't

try. But the women are also worried about the reality outside, including the ever-present rule of the gun. "If there is no security in our country, how can people participate in elections?" frets Afifa Azim, director of Afghan Women's Network, a nonprofit organization in Kabul.

A simple question—and one impossible to answer right now. Two years after the U.S. toppled the

fundamentalist Taliban regime, Afghanistan's political and economic transition is lurching forward. The next nine months, the runup to the country's first-ever free elections, will be critical. In a schedule agreed upon by the Afghans, the U.S., and the U.N. just after the war, Afghanistan must by next June finish drafting its constitution, hold a constitutional *loya jirga*, or grand council, to ratify it, conduct a census, and register millions of voters—most of whom are illiterate and have never cast a ballot.

Such a political agenda would be ambitious under any circumstances. But all this is happening at a time when American and Afghan security forces are battling resurgent Taliban fighters in the country's southwest. The Taliban have been conducting frequent ambushes. In the first week of September alone, four employees of international contractors working on the new Kabul-Kandahar highway disappeared, while six were killed. Meanwhile, a pilot U.N. program to disarm provincial warlords and their armies has been delayed. "Every attempt is being made to meet the challenges, but the challenges are enormous," acknowledges Sultan A. Aziz, an Afghan-American who is senior adviser to Lakhdar Brahi-

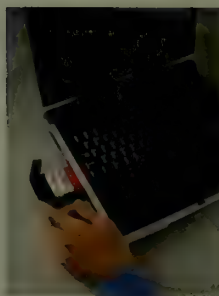
By next June, Afghanistan must draft a constitution, ratify it, conduct a census, and register millions of voters

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average
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mi, the U.N. special representative for Afghanistan.

The continued instability is one reason some experts favor postponing the elections. "There have to be very major improvements in security and in the legitimacy of the government in certain areas of the country," warns Barnett R. Rubin, the director of studies at New York University's Center on International Cooperation who has worked through the U.N. as an independent expert with the Afghan constitutional commission. "Forcing elections too quickly could create conflict," he adds.

So far, though, most officials from Kabul to Washington seem determined to keep to the timetable. In fact, the looming election is spurring efforts to speed up reconstruction and reform projects, from revamping the banking system to vastly increasing the size of the police force (table). A free and fair election in Afghanistan next June would mark an important success for the Bush Administration, just a few months before President George W. Bush faces reelection. That is why Bush plans to double the amount of U.S. aid to Afghanistan, to \$1.8 billion a year. For their part, Afghans, who fear aid will slump after their elections, are hustling to make as much progress as they can.

Indeed, Afghanistan's ministers are working overtime to meet their targets. At Da Afghanistan Bank, the country's



central bank, Governor Anwar-ul-Haq Ahady is proud that he has stabilized the afghani, the local currency, and kept it trading at around 50 to the dollar. He recently granted licenses to three foreign commercial banks—Britain's Standard Chartered Bank, National Bank of Pakistan, and the Geneva-based Aga Khan Foundation's First MicroFinance Bank—to operate in Kabul. And he's setting up 84 branches around the nation for deposit and savings accounts.

Just down the road from the central bank, in Kabul's 18-story telecommunications tower—the city's tallest building—Communications Minister Mohammad Masoom Stanekzai is plotting a \$100 million overhaul of the country's phone network. Land lines no longer work in Afghanistan, and cell-phone service is limited.

NEW WAYS Women studying English in Kandahar

Phones are particularly scarce among locals. But the new system will combine satellite services, cell services, and land lines to connect 15 cities by mid-2004 and the country's 32 provinces by 2005.

Some visiting business people see improvements. When U.S. executive William J. Cleary arrived in March, "there was nothing—no roofs, no power, no phones," he says. "But it

has been changing at lightning speed," adds Cleary, who is working with Washington-based consultancy BearingPoint Inc. to advise the Finance Ministry.

Little progress can be seen outside Kabul, however. With average annual per-capita income estimated at \$125 or less, Afghans remain desperately poor. Most live in mud-brick huts. And four years of drought have destroyed the livelihood of farmers, who have boosted their cultivation of illicit poppy far above last year's level to raise their incomes.

The poppy crop worries Kandahar Governor Yusouf Pashtun. He blames opium, Taliban insurgents from Pakistan, and decades of ineffective government in Kabul for ongoing violence. "Terrorist activity has increased in the region because the government has failed to be present here for 20 years," he argues. Still, Pashtun hopes to bring schools, hospitals, and telecoms to his province—to improve living standards and presumably

build a political base before elections.

Whether Afghanistan succeeds in carrying out democratic elections next year will depend on how the Afghans, U.N. officials, and the Bush Administration work together in the coming months. A key step will be completing and ratifying the constitution. Although it's still being debated behind closed doors in Kabul, most Afghanistan-watchers hope the document will establish a directly elected presidency and two-chamber Parliament, and that strict *sharia*, or Islamic law, won't play a major role. That would likely please many of Afghanistan's 14 million women, half the population. But they will still have to worry about the men with guns—and the fear and violence they bring.

By Manjeet Kripalani in Kandahar

Remaking Afghanistan

THE PACE IS PICKING UP...

POLITICAL A constitution is being drafted that would set the stage for national elections in June, 2004.

SECURITY The Kabul government's goal is to boost the police force from 2,000 to 20,000, while expanding the Afghan army.

INFRASTRUCTURE A \$100 million project to overhaul the telecom system is under way, while work on a major highway from Kabul to Kandahar is accelerating.

...BUT MAJOR CHALLENGES REMAIN

POLITICAL Time is short for completing a census and voter registration before the elections.

SECURITY Resurgent Taliban fighters are clashing with U.S. and Afghan forces, while provincial warlords still run private armies.

POVERTY Despite U.S. plans to boost aid to \$1.8 billion a year, Afghans can expect to live in dire conditions for years to come. Annual per capita income is \$125 or less.



BIG JOB:
KARZAI

Data: BusinessWeek

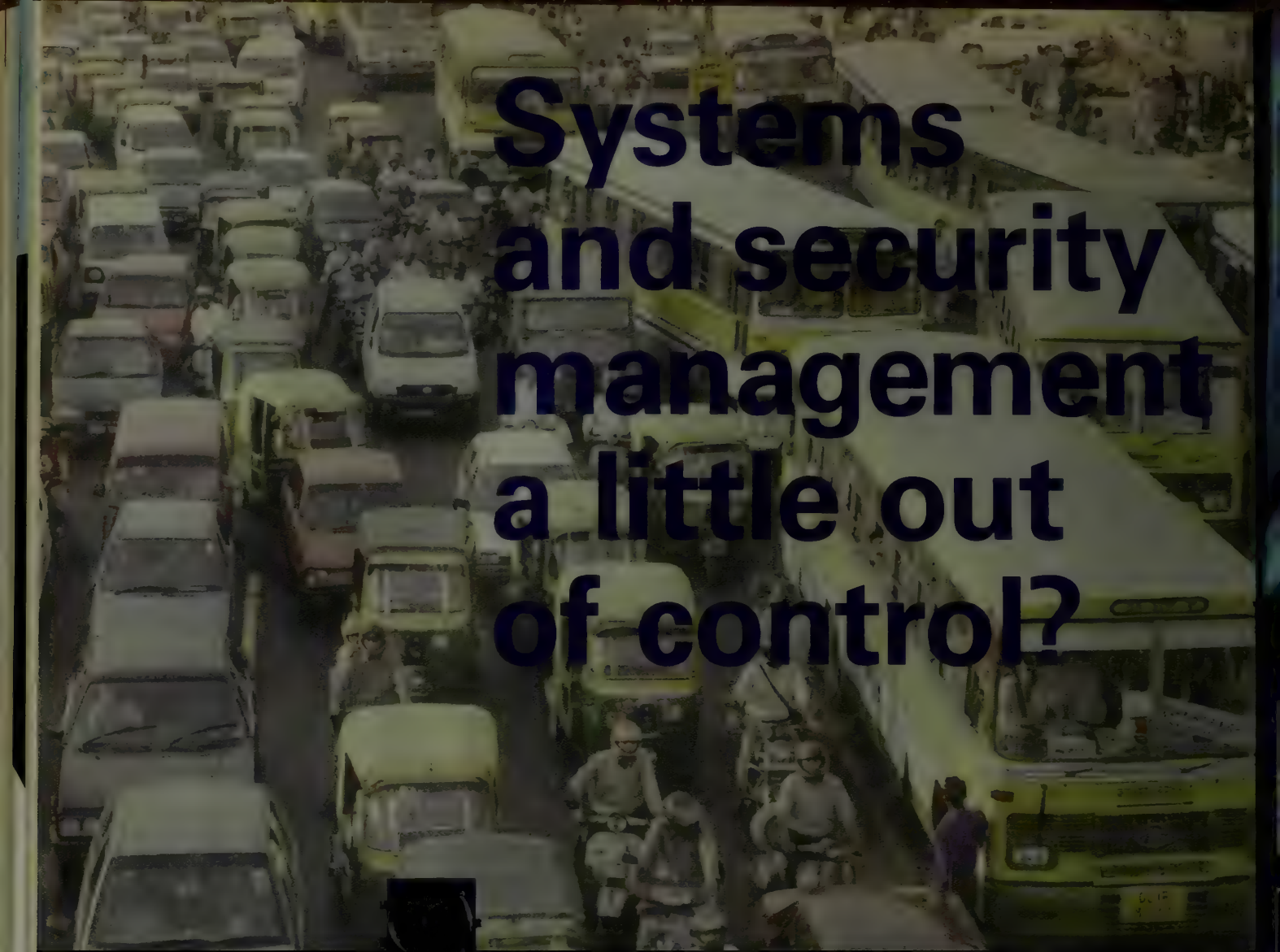
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ADVANTAGE:

INFRASTRUCTURE

An agile network requires a fresh look at everything from data standards to legacy apps.

INFRASTRUCTURE isn't just simple "plumbing."

In many cases, it's the key to making your business more responsive to customers and partners. No wonder the ever-more-pressing demands of business are causing smart companies to rethink long-held notions of how to choose, implement and manage IT infrastructure.

Enjoying the advantage of an agile and adaptable end-to-end infrastructure isn't simply a matter of selecting the best hardware, software, storage and connecting pipes. Increasingly, getting the right kind of plumbing in place requires new kinds of plumbers — shaking up IT and business staffs, re-evaluating how companies judge standards and network components, and anticipating changes that will place greater demands on the infrastructure than many imagine — and sooner rather than later.

The reality, analysts say, is that most IT infrastructures are out of control. CIOs are under pressure to find quicker and cheaper ways to access information. The obvious fix is to slap down some middleware or put up a new portal. And that works — for the moment. And it's certainly faster and less expensive than sizing up new infrastructures or striving for commonality of applications — for the moment. The problem is that the underlying complexity grows each day. And so, little by little, the infrastructure starts to wheeze under its own weight.

Experts say the agility and performance that companies require from their networks can no longer be achieved by simply adding on. Often, they must take away parts of the infrastructure or change their approach and, certainly, they must think for the long term.

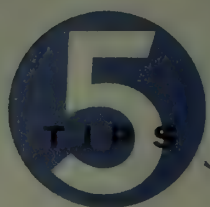
Lack of Discipline

Most IT infrastructures have become unwieldy because of a lack of discipline, experts say. Large companies that have been early adopters of data, voice and video networks, for example, should begin to combine them and reduce costs. They need to step back and look at the makeup of their infrastructure.

In the booming 1990s, many new application projects tied their ROI justification to the cost savings from replacing legacy systems. Companies launched new client/server applications that did away with the need for old-line infrastructure. Of course, the legacy systems kept running as insurance during the trial periods for the new systems. In many cases, though, the old apps were never shut off after the trial ended.

"The problem is, the business line never said to shut the applications down and the IT department didn't have the authority to shut them down," says Colleen Niven, vice president of research for AMR Research, an independent research analyst firm in Boston.

And so those now-unnecessary legacy systems keep going — and so do the costs of main-



Clean Up Network Clutter

1.
Make sure older apps are shut down after new apps are fully tested.
2.
Discard repetitive data rather than build new systems to store it.
3.
Tie data, voice and video networks together to reduce costs.
4.
Bring facilities under the aegis of IT to improve agility.
5.
Don't wage war over standards that only affect the most visible functions.

tenance and software licensing agreements. The only thing that has disappeared is the ROI that was supposed to be gained by shutting down the legacy systems.

Infrastructure is a long-term purchase. The ROI should be considered in terms of a five-year horizon rather than five months. "Infrastructure isn't cheap or easy," says Chuck Hollis, vice president of storage platform marketing for EMC Corp., a storage vendor in Hopkinton, Mass. "It's a change of business model. If you look at infrastructure as something as important as, say, going into a new market, you get the right level of senior executive involvement." The ROI model for infrastructure projects should have both hard attributes, like reduction of churn, and soft attributes, such as increased flexibility.

Wireless Affects Everything

Over the next 18 months, infrastructures will be struck with another whammy: the proliferation of wireless devices that must be wired back into the infrastructure.

Many companies don't appreciate that some of the most troublesome aspects of wireless, such as security, are really matters of policies and planning rather than technology, says Alan Nugent, chief technology officer for Novell Inc., a networking software company in

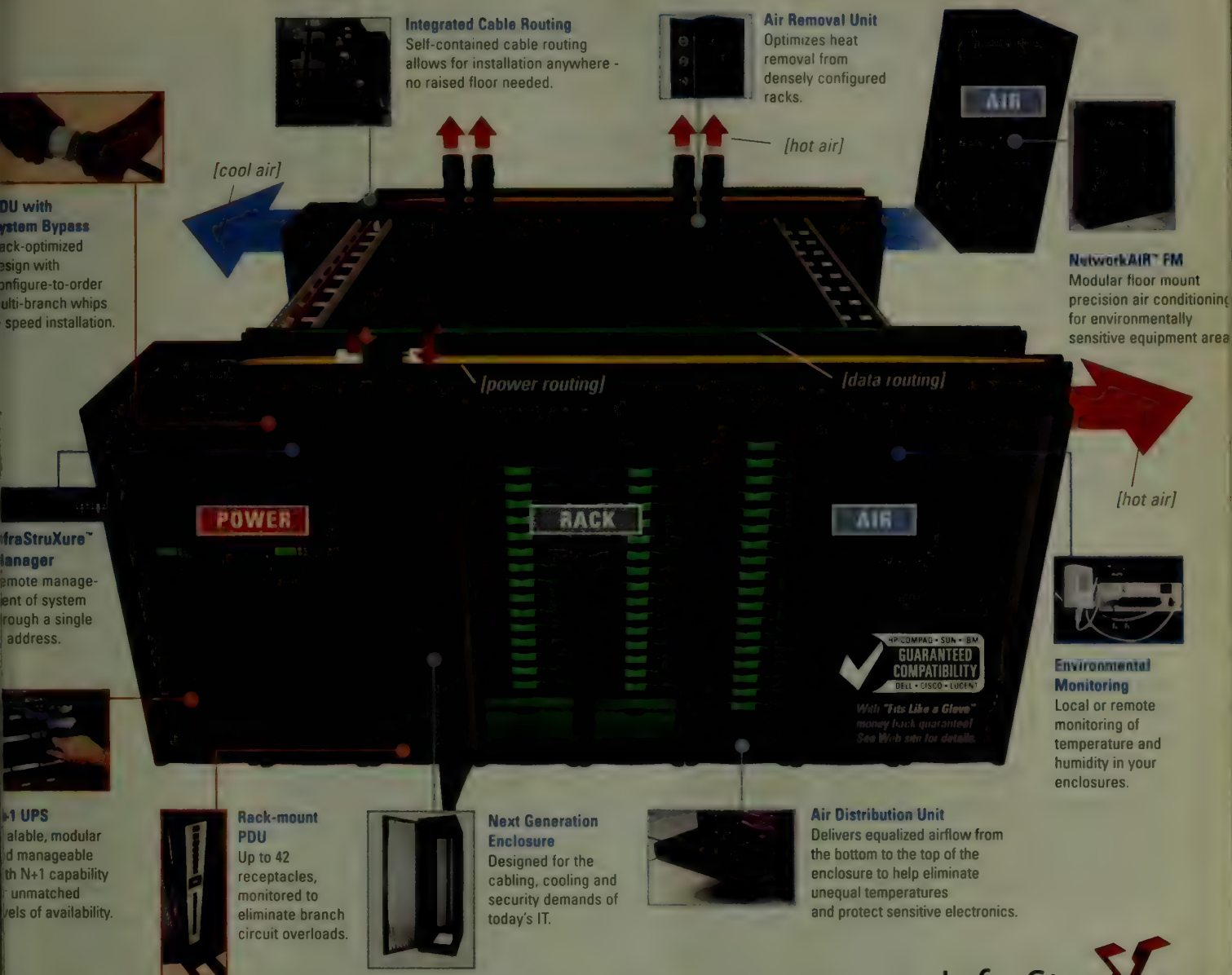
Provo, Utah. "Before companies widely adopt wireless devices, they need to decide on their policies for using these devices in day-to-day business activities," Nugent says.

Consider the problem of how to protect valuable information that executives download to their laptops or PDAs. Some companies require users to input a separate password for each application on a wireless device in addition to the password they use on devices wired to the infrastructure.

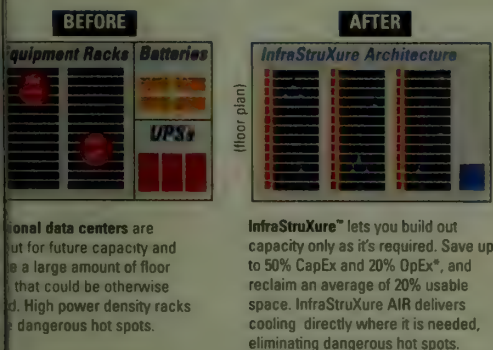
"That can be really burdensome," Nugent says. "Your policies need to be realistic, because you don't want the user to ignore the security proce-

(continued on page 7)

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Bringing SLAs Inside

IT organizations no longer have the luxury of servicing only internal employees. When companies expose their infrastructure directly to customers, partners and suppliers, it increases both the complexity of the environment and the need for maintaining service levels.

One method increasing in popularity is the use of formal service-level agreements (SLAs) between IT and its internal customers. "Adopting service-level management across the entire IT organization gives the IT staff a common set of goals and values," says AMR Research Analyst Dennis Gaughan. "When an entire organization is working toward the same goals, it becomes more aware and proactive in delivering quality service."

A fundamental part of developing effective SLAs is having IT work closely with business customers to understand their requirements. In many cases, though, this isn't happening. Consider a survey conducted by AMR Research of 58 companies across many industries that have implemented internal SLAs. Only 53 percent of those companies involved line-of-business counterparts in the SLA creation process, despite widespread agreement that working with customers was a critical factor.

Change is Key

To create successful SLAs, IT organizations often need to change how they manage and measure service delivery. Traditional measurement of discrete device availability, like server uptime, doesn't reflect business performance as accurately as key business services, like order management.

"What to measure?" and 'How to measure?' represent some of the biggest challenges in the successful implementation of SLAs," AMR's Gaughan says. "Working closely with the customer to determine the metrics that are important to the business is a critical success factor."

Another key point: Because

business is constantly changing, there definitely will be changes to what the SLAs measure.

Unless companies focus on service-level management and think about the process of creating an SLA, they tend to manage their infrastructures in a reactive — rather than a proactive — way, says Scott Hollis, senior director of marketing for NetIQ Corp., an analytics, systems and security management firm in San Jose, Calif.

Too often, business units launch and manage their own Web farms until they realize they have built a mission-critical Web site, at which point they turn the site over to IT. "IT has done none of the pre-work, nor have they built any of the architecture, so they have to try to manage it in a production environment while they build an architecture that they can effectively manage," Hollis says. This is especially common in Linux or open-source environments, which the business units think are less costly because the downstream management issues haven't been addressed.

The result is more cost and poorer performance until the new architecture is constructed.

Hollis says these problems can be minimized with better planning. Business units need to think through three elements before deploying a new business service within an infrastructure: assuring the service's availability; optimizing it for end users and support staff; and supporting it.

Internal SLAs Work

Even with some faulty measures, the results of internal SLAs have been impressive. It's important to note, however, that SLAs don't necessarily cut costs. A third of the companies in the AMR Research survey said SLAs actually increased operating costs.

But even this, experts say, can be a sign of success: Higher support costs often mean the company has set a higher bar for performance and infrastructure availability, which pays for itself in the long run. ■

Why Executives Are Changing Their SLAs

47%

Change in Business
Priorities

39%

Difficult to Measure

35%

Customer Requests

28%

SLA Terms Too Restrictive

19%

Compliance Too Costly

Source: February 2003 AMR
Research survey of 58 companies
across many industries

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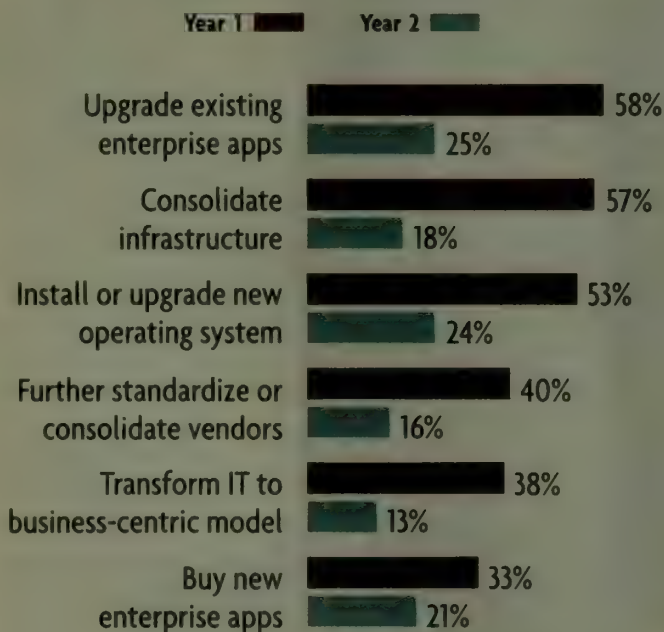
dures or look for ways to bypass them." Instead, the company might decree, for example, that only encrypted data can be stored on a mobile device. Or it might implement management systems to render the data unusable if the mobile device is lost.

Reshaping IT Departments

Another way companies are looking to make their infrastructures more responsive is by reshaping their IT departments. Over the next 12 months, AMR's Niven expects to see a return of chargebacks for basic infrastructure, a notion largely abandoned during the flush 1990s. Rather than clumping infrastructure into one big budget item,

Upgrade, Consolidate or Transform?

Where will companies spend their infrastructure dollars over the next two years?



Source: Forrester Research telephone survey of 122 IT executives worldwide

system and service management tools purchased from major vendors will break down the cost that a specific application used by a specific business unit has to infrastructure.

IT departments are making stronger connections with facilities departments, too. "Historically, IT and facilities departments have not meshed," says Russell Seneca, solutions manager for InfraStruXure at American Power Conversion (APC) Corp., a power availability solutions

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provider in West Kingston, R.I. "Facilities became the scapegoat for why IT could not implement projects quickly enough."

Now, companies are creating posts such as "Critical Facilities Directors," whose job will be to determine, say, how implementing an Oracle or CRM tool will affect facilities to keep that department from being a bottleneck. Seneca

says thinking of facilities as infrastructure could cause companies to change their philosophy for how they should architect cooling and power systems, for example. Typically, those systems are overbuilt based on predictions of the lifetime needs of a datacenter. Now, more companies are using modular, highly manageable and pre-engineered components for their air and power systems.

More From Suppliers

The relationship many companies have with their suppliers is changing, as well. CIOs have been asked to cut back significantly on spending, resulting in only 20 to 30 percent of the budget going to new applications and infrastructure. "Companies are reducing the number of suppliers to create more leverage with remaining suppliers," says Doug Tuttle, global high-tech leader for Deloitte Consulting in New York. "They want vendors to help with infrastructure consolidation ideas."

Companies that find new ways to work with suppliers, customers and colleagues have learned to look at their infrastructures from an entirely different perspective. And this has allowed them to construct robust and agile infrastructures that can meet the growing demands of business. If all goes well, that should give them an advantage. ■

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HOW LONG WILL BEIJING KEEP PLAYING IT COOL ON TAIWAN?

Tung Chee-hwa, the Beijing-selected chief executive of Hong Kong, surprised the former British colony on Sept. 5 by withdrawing controversial anti-sedition legislation that he and Chinese leaders had been promoting for months. The move marks a triumph for the 500,000 protesters who demonstrated against the bill in the city's streets in July.

Yet the backdown in Hong Kong comes just as Taiwan is entering its presidential election season. In past elections, China has fired missiles and held war games to scare voters away from anti-Beijing candidates, which has often backfired as Taiwanese voters rallied around politicians Beijing disliked.

This time, the Chinese regime seems to want to avoid such a backlash. That may be one reason why China's inexperienced new President, Hu Jintao, allowed Tung to pull the anti-sedition bill. The Chinese leadership does not want to give any more ammunition to Taiwanese President Chen Shui-bian, the Beijing critic who has used Hong Kong's civil-rights battle to win support for his reelection bid next March. Chen is leader of the Democratic Progressive Party, long identified with the movement to declare Taiwan independent.

Beijing has also responded mildly to recent provocative moves by Taiwan. On Sept. 1, Chen's government for the first time issued passports with the word "Taiwan" printed on them rather than just the official "Republic of China" that preserves the idea that the island remains part of China. A few days later, 100,000 people demonstrated in Taipei, calling for the government to drop the China name altogether, in an event led by ex-Taiwan President Lee Teng-hui—one of the tools China loves to hate. Normally, such moves would inspire a vitriolic response, but so far the Chinese have ratcheted

down their rhetoric. "Hu Jintao is still working to consolidate his position," explains John Chang, a fellow at Taiwan Research Institute, a Taipei think tank. "The timing would not be good for him to do anything big."

The question is, how long Beijing will stay on its best behavior? Chen was elected with just a plurality in a three-man race in 2000 and has since presided over an economic slump. He is not popular and faces a unified opposition. So he may push the envelope in an attempt to get a clumsy Chinese response and thereby rally voters to him. Lee used such tactics in 1996, when the Chinese fired missiles near Taiwan.

The Chinese may also find it hard to stay silent as policymakers in Taiwan and the U.S. urge a response to Beijing's military threat. The Pentagon recently reported that China had at least 450 missiles pointed at Taiwan and was adding 75 a year. "There is no question that [China] has decided to step up its capabilities," says Douglas H. Paal, director of the American Institute in Taiwan and de facto U.S. ambassador. Some Taiwanese want missiles capable of hitting Shang-

hai. "They threaten me, I need the ability to threaten them," says Li Wen-chong, a DPP legislator.

Chen will have to walk a fine line. Aware that Taiwan's high-tech companies depend on Chinese factories for production, Chen's government recently issued proposals to improve economic ties with China. "Taiwan needs to maintain a steady course and not antagonize the 800-pound gorilla," says Alexander Huang, vice-chairman of Chen's Mainland Affairs Council. Still, come election time in Taiwan, leaders in Taipei, Beijing, and Washington will again struggle to keep their cool.

By Bruce Einhorn in Taipei



TAIWAN FLAGS: A growing move for independence

GLOBAL WRAPUP

SHAKEUP IN BRITISH SOCCER

► Roman Abramovich, the wealthy Russian businessman who bought control of Chelsea Football Club in July, has pulled off another shocker. On Sept. 9 he lured away Peter Kenyon, CEO of Manchester United PLC, Britain's best-known and best-managed sports business. Abramovich has spent \$170 million on high-profile players since completing the Chelsea deal for an estimated \$210 million.

Analysts speculate that Abramovich may be hoping that Kenyon, a former

marketing executive, can repeat the successes he achieved at Man U in boosting the team's brand by selling shirts and other products around the globe. Abramovich's spending is likely to put further pressure on British clubs, several of which are struggling under soaring player costs.

CLASH IN COLOMBIA

► Colombian President Alvaro Uribe, who has been cracking down on a 39-year-old guerrilla insurgency and the country's cocaine producers since he came to power in August, 2002, is now

clashing head-on with human-rights groups. On Sept. 8 he publicly blasted activists for criticizing his efforts, calling them "spokesmen" for terrorists.

In a new report, Colombia's leading nongovernmental groups allege that the Uribe government has arbitrarily detained more than 2,500 people, including labor unionists and opposition politicians, accusing them of supporting guerrillas. The verbal slinging match may dent Uribe's popularity, but it is unlikely to affect U.S. aid to Colombia, which has totaled \$2.4 billion since 2000.

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Want to know how DigitAll works for me? Let me tell you what happened last week at work...

Even before I began working for the Company, I'd heard about Marvin Derwish, its CEO. It's hard not to. Marvin is everywhere—on all the TV news and chat shows and on magazine covers. Last week, I even saw his face plastered on the side of a bus, advertising his latest book. Marvin is about as rich and famous as a CEO can be—and about as demanding as you might imagine.

Marvin takes being connected to new heights. The day I joined the company,

I was issued the standard company cellphone. No ordinary phone either: a new Samsung Mobile Intelligent Terminal (MITs), the SPH-i700. "Smart workers, smart phones," says Marvin, but he might as well have put me on a leash. The i700 is such a cool phone, I literally can't go anywhere without it. It's not just a phone, it's a way of life. And not only because it's fun—I mean how many people do you know have 40 polyphonic ringtones that ring with the sounds of Radiohead? But mostly the i700 is just so useful. With the whole suite of Pocket PC applications, my whole life is on this thing. Last week, I found myself doing a business proposal using Pocket Word and then crunching some numbers in Pocket Excel—all on my lunch hour. And all on my phone.

*"The Samsung SPH-A600
isn't just for talking—
it's for seeing!"*



Naturally, it's also fun to play with the little 300,000 pixel camera. (Marvin always pushes us to take pictures of our products anywhere we go; \$100 to anyone who finds our displays out of order.) Likewise, the dial-your-number-by-voice feature comes in handy a lot: now my wife lets me drive and talk on the phone at the same time. But you haven't really lived until the boss sends you an instant message while your three-year-old is pitching a tantrum in the supermarket (that would be the ice-cream aisle.)

Yet no matter how connected Marvin wants us to be, there's one place we're supposed to be offline—when we're meeting with Marvin. "Turn on your job and turn off your phone," is the first thing you hear when you meet Marvin.

At least that was the law until last week when I got a call from his assistant asking me to step into his office. As soon as I walked in I saw Marvin's new Samsung SPH-A600 lying on his spotless desk.



He looked particularly stern, while the phone gleamed distractingly. I was sure he was going to fire me, although I couldn't figure out why. "Do you know why I've called you here?" he said, closing the door behind him.

"No sir," I gulped.

Just then his A600 rang. I was a little confused for a second. I already *knew* it wasn't my phone—mine was much thinner, for one thing—but if it's a crime for your

phone to ring when you're meeting the boss, what are you supposed to do when the boss's phone rings?

"Answer it," he commanded with a snap of his hand. "Now."

I reached over his desk, and snapped open the phone. It was light as a feather, and I thought I was going to drop it. "Mr. Derwish's line," I said, a little foolishly. And

just then I saw my wife's picture on the phone's amazing 65,000 color screen. I thought I was hallucinating. For one thing the screen was so big! (Two full inches, 12 lines of text, I learned later). For another, my wife looked like she was on the cover of a magazine. "Happy birthday, you big dope," I saw her message as I looked at her huge smile, my three-year-old beaming from her lap. "You were working so hard, I didn't know if I was going to see you, so when I ran into Mr. Derwish last week, we cooked up this little surprise."

I looked at Marvin's phone, looked at my wife, and realized there was only one thing to do. Luckily, the A600—with its 180-degree pivoting LCD and rotating camera—was just the phone to make it happen. "Thanks Marvin," I said, pivoting the camera around to him so I could take a photograph of this momentous (and rather silly) moment. "Now I'm gonna be in big trouble."

"You don't know just how much trouble," said the big man. "If you think you're in trouble now, just wait till you see what happens when you get home!"

It suddenly occurred to me that my wife and I do not own a digital camera—at least, we hadn't when I left home this morning. And yet here she was, live and in color, on every single pixel of Marvin's phone.

"Honey, this is all wonderful, but can you tell me how you're taking pictures of yourself on a camera phone?"

"Better come home soon, tiger," she said. "You don't want me to tell all my tricks in public do you?"

It was time to thank Marvin and get home. The real party was just about to begin.

So do like I did: grab a cool drink, turn up the music, and join the DigitAll party—everyone's invited to share our vision of tomorrow's mobile phones right now!



SPH-i700



SGH-E700



SPH-A600

SAMSUNG

COMMENTARY

By Catherine Yang

HOW MICHAEL POWELL COULD HAVE THE LAST LAUGH

Federal Communications Commission Chairman Michael K. Powell looks like a man on the run. Since he passed sweeping rules in June enabling greater media consolidation, an angry public has ignited a fast-burning backlash against his deregulatory agenda. On Sept. 3, at the urging of public interest groups, the U.S. Court of Appeals in Philadelphia stayed the rules until it could finish reviewing them. The next day, the Senate Appropriations Committee voted to bar the FCC from implementing a new rule allowing TV networks to own stations covering up to 45% of the U.S. audience.

But while the opponents of media consolidation seem to be gaining ground fast, they shouldn't be too quick to declare victory. In fact, Capitol Hill's expected repudiation of the networks' 45% limit risks letting the steam out of the debate—and leaving Powell's laissez-faire legacy intact. Until now, lawmakers and the anti-Big Media insurgents have focused on gutting this one rule. The 45% cap has become a rallying symbol, but the regulations that would truly reorder America's media landscape and affect local communities have flown under the radar. These would allow companies to snap up not only two to three local TV stations in a market but also a newspaper and up to eight radio stations. If the courts and Congress are worried about the dangers of media consolidation, they'll have to resist calling it a day after dispensing with the network cap and go after the rules with real bite.

As it stands now, TV's Big



AGENDA INTACT? Some of Powell's new rules remain under the radar

Four networks will be losers among media outlets—thanks mostly to vociferous lobbying by independent TV affiliates. With strong ties to lawmakers who depend on them for campaign coverage, the affiliates have succeeded in getting a House vote against the 45% rule and will likely see a rerun of that episode when the Senate votes by October. But with Fox and CBS already each owning stations that cover about 40% of the nation's audience, “going up another 5% isn't going to make a dramatic difference,” says Scott A. Stawski, a media consultant at Inforte in Chicago.

In contrast, opening the floodgates to allow local behemoths to combine newspapers, TV, and radio stations under one roof would change media ownership in towns and cities, concen-

trating it in the hands of a few. Even in midsize cities, such as San Antonio, for instance, one company might own the leading newspaper, two TV stations, eight radio stations, and several cable channels. Powell argues the explosion of cable networks and the Internet brings a wide choice of media to communities, even if there's a spate of mergers. And—no surprise here—most media companies agree.

Yet there's little doubt that, once given the go-ahead, these rules would spur local consolidation. Owning a second or third station in a market is irresistible for TV station owners, which can slash expenses by a third by ditching duplicate cameramen, studio technicians, and reporters. The economics of newspaper-broadcast cross-ownership may be dicier, but publishers such as Tribune Co., Gannett, and Media General want stations where they publish—if for nothing more than to cut costs in back-office operations.

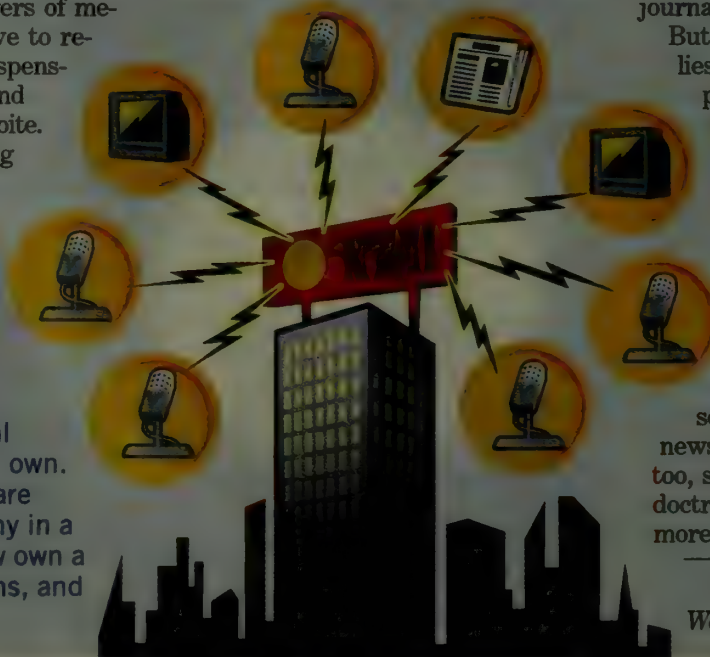
True, the new media giants could conceivably plow their savings back into improving local news coverage. But public companies are more likely to use them to boost returns to shareholders. “If they can downsize the operational budget through having fewer people cover the news, they'll do it,” says Jill Geisler, head of the leadership program at the Poynter Institute, which promotes journalism standards.

But even asking whether TV duopolies and newspaper-TV combos can produce better news may be beside the point. “The test is how many different voices we have,” says James F. Goodmon, CEO of Capitol Broadcasting Co., a Raleigh (N.C.)-based TV station group that is opposed to the FCC's rules. “What's good news to you is bad news to me. I'm really worried about someone deciding what good news is.” The courts and Congress, too, should guard against a Powell doctrine that could end up muffling more voices than it adds.

Yang covers the FCC from Washington.

THE MAKING OF A LOCAL MEDIA GIANT

Congress is expected to overturn a media rule expanding how many local stations a TV network can own. But other new FCC rules are more potent: One company in a medium-size city can now own a newspaper, two TV stations, and eight radio stations.



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MAGIC MAN:
*Chang's
Trend Micro
is one far-
flung outfit*

ized like most companies. It has spread its top executives, engineers, and support staff around the world to improve its response to new virus threats—which

can start anywhere and spread like wildfire. The main virus response center is in the Philippines, where 250 engineers are willing to work the evening and midnight shifts necessary to keep ever-vigilant. Then there are six other labs scattered from Munich to Tokyo. "With the Internet, viruses became global. To fight them, we had to become a global company," says Chairman Steve Chang, a Taiwanese who started the company in 1988.

Trend Micro is among a new breed of high-tech companies that's defying conventional wisdom about how corporations ought to operate. While most large companies have extensive worldwide operations, these companies go much further—aiming to transcend nationality altogether. C.K. Prahalad, a professor at the University of Michigan Business School, calls this the fourth stage of globalization. In the first stage, companies operate in one country and sell into others. Second-stage multinationals set up foreign subsidiaries to handle one country's sales. And the third stage involves operating an entire line of business in another country.

What's different about these outfits—call them transnationals—is that even the executive suite is virtual. They place their top executives and core corporate functions in different countries to gain a competitive edge through the availability of talent or capital, low costs, or proximity to their most important customers. Trend Micro's financial headquarters is in Tokyo, where it went public; product development is in PhD-rich Taiwan; and sales is in Silicon Valley—inside the giant American market. When companies fragment this way, they are no longer limited to the strengths, or hobbled by the weaknesses, of their native lands. "This is very new, and it's important," says Prahalad. "There's a fundamental rethinking about what is a multinational company," he says. "Does it have a home country? What does headquarters mean? Can you fragment your corporate functions globally?"

There has long been talk of the stateless corporation—*BusinessWeek* even ran a cover story on it in 1990. Yet the dispersal of key corporate functions takes the idea one step further, and it's made possible by advances in technology, especially the Internet. Harvard Business School Professor Christopher

STRATEGIES

BORDERS ARE SO 20TH CENTURY

High-tech transnationals take "stateless" to the next level

When the first reports surfaced at 12:17 p.m. Pacific Time on Aug. 11 that the Blaster computer virus was on the loose, researchers at antivirus-software company Trend Micro Inc. scrambled to come up with a fix. Meanwhile, the company's five global alert commanders began sizing up Blaster via cell-phone calls and e-mails. At 1:55 p.m., Hamud Saway, the commander based in

Japan, declared a global alert, signaling that this virus was nasty enough to require all the company's resources. Just 51 minutes later, a cure was ready. The company routinely is among the first responders to viruses, often delivering 30 minutes before market leader Symantec Corp., according to GEGA IT-Solutions in Germany, a response tester.

Trend Micro is able to respond so quickly partly because it's not organ-

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78759	01889	48243	73110	14231	91791	80041	29410	88109	55343	22204	78208	39296	07630	08048	20818	37932	76104	90
70122	78223	23249	73163	33141	18914	79935	32801	43652	29648	33304	92177	14264	08055	36104	08008	61613	84120	95
63147	36114	77091	91319	52407	19014	17699	78719	48017	28219	19607	14519	94103	84112	07307	85708	90099	43235	33
90249	10583	84104	19601	18040	44311	25404	40282	68517	79452	33484	95125	18398	66203	36057	20723	43203	80058	90
58406	55435	28804	27606	36633	06142	91614	91361	80799	90031	90013	07104	07450	23488	22336	27560	43201	07470	90
30341	37604	94593	90046	67233	52907	94603	36106	07702	43619	91942	80095	32707	23806	80299	10043	20722	20522	64
07739	91214	91767	75044	95127	01615	94133	12250	24203	25358	77710	30042	33238	95009	61821	23863	71033	32008	06
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32301	85288	40524	25406	10962	25301	91778	89121	03688	73134	85001	91402	14616	50325	24153	22156	07007	34235	92
60301	28244	20566	33443	32302	28290	49512	32606	21289	15140	84004	15277	83716	72210	48152	23278	04116	81409	21
49415	78716	77082	90082	08055	19013	39207	08852	54602	85077	34232	34276	74170	40282	26105	93111	06141	45415	60
27410	85227	94137	11211	92551	80014	50334	49401	22009	06531	98134	06154	25713	80290	10033	85715	92859	92412	27
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06511	80322	80682	11378	06913	35898	54136	84106	73179	35615	78778	07882	44194	70802	98112	20192	83103	30082	19

The merger with Airborne has made DHL stronger in these areas:

80281	14580	46223	94519	15203	84037	02919	23704	77429	79588	33628	75384	27868	24014	73075	29402	27619	72103	77003	27
28410	10032	84135	46225	68544	91946	22008	07660	46741	10467	70629	77237	98027	43667	46808	08422	69701	20810	18103	07
02118	55124	33624	19188	73130	29260	19187	78768	22227	80634	49516	17121	43904	63110	97216	29404	63021	95626	80063	14
46743	48554	20390	43212	91735	10090	20124	95164	44177	91201	55103	75060	54302	46227	91108	19083	80007	31139	78007	20
11223	99210	34243	92403	23504	37916	91729	07458	78552	66223	33714	85254	20597	99201	14604	19538	01854	80094	10004	10
15120	60107	11358	43218	37311	60402	93150	23666	17364	92335	85722	94587	10089	55111	35805	02284	15283	80063	33006	14
32793	80706	64125	20077	44136	75390	64123	80150	46253	02140	01109	80280	15264	48157	70507	34233	67227	10404	90006	30
77053	45052	30126	37716	30305	03063	90261	13224	46404	37620	32828	33913	91773	33110	61636	11771	84122	54205	30006	14
45274	32641	01760	19191	64113	92145	21162	33420	07734	92335	20375	91121	95120	15253	02468	84115	57789	88110	47006	14
33603	92681	43228	20018	73105	08008	07961	38112	53793	01144	78240	44308	93094	97205	74119	80247	06673	91711	02006	14
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90088	08723	95814	91118	33174	44712	02148	32735	32829	21279	19004	19177	14621	15056	91104	82801	20318
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37663	18517	75082	74183	12202	55458	53209	20539	53788	66250	08880	33916	78760	07980	55345	11235	92117
80305	73111	77268	20029	95351	10986	80697	43571	48334	28288	20410	10029	60305	21285	48141	21287	07077
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75294	91326	84408	92625	23234	84030	60546	77238	20254	73170	60621	90223	57101	92142	90017	22101	07513
02136	45267	15146	20757	40217	30344	50021	10015	80225	78713	17120	74149	80028	97404	13116	32935	88559
17415	75270	80407	33327	91911	06517	64109	82074	20524	93305	44190	82406	75379	82809	60599	50323	02500
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Information Technology

A. Bartlett says improved communication is allowing an evolution toward "an integrated global network of operations." To deal with the gaps between time zones and cultures, these tech transnationals operate like virtual computer networks. Thanks to the Internet, they can communicate in real time via e-mail, instant messenger, or Web videoconferencing. Over time, these scattered experiments could coalesce into a powerful new model for business. Bartlett and other management experts say the strategy of truly globalizing core corporate functions is applicable for all kinds and sizes of companies.

Tech's transnationals are popping up all around the world. They range from business-intelligence-software maker

Business Objects, with headquarters in France and San Jose, Calif., to Wipro, a tech-services supplier with headquarters in India and Santa Clara, Calif., to computer-peripherals maker Logitech International, with headquarters in Switzerland and Fremont, Calif. While no one tracks the numbers, *Business Week* interviewed executives at a dozen such companies, and new ones keep popping up. For instance, 24/7 Customer, a business-services provider with headquarters in Los Gatos, Calif., and Bangalore, India, just raised \$22 million from Silicon Valley venture capitalists.

Running a transnational company is a tough management challenge, though. Executives are separated by oceans and time zones, making it difficult to main-

tain basic communications and routines that old-style companies take for granted. Then there are the cultural chasms. "The curse is that national cultures can be very different," says Trend Micro's Chang. "We have to figure out how to convert everybody to one business culture—no matter where they're from." That's why Chang is visiting the company's 20-plus sites and laying out a set of common values. Chang, who learned to do magic tricks when he performed at his parents' bowling alley in Taiwan during his youth, breaks the ice by performing sleight-of-hand with cards or coins.

In spite of the complexities of spanning the globe and a sluggish economic environment, most of these tech trans-

TECH'S TRANSNATIONALS

A group of tech industry companies are taking multinationalism to extremes—spreading key headquarters functions around the world—in an effort to be more competitive. Here's a sampling:

TREND MICRO

Having a computer-virus response center in low-cost Manila and six smaller virus-response labs scattered around the globe allows this Taiwanese/American/Japanese company to guarantee delivery of inoculations against major viruses in less than two hours. No rival virus company has such international reach.

LOGITECH INTERNATIONAL

With dual headquarters in Switzerland and Silicon Valley, Logitech holds its own against mighty Microsoft in computer peripherals. One key advantage: The manufacturing exec is in low-cost Taiwan. That helps Logitech make quick decisions about whether to manufacture products in its Chinese factories or farm them out.

I AM A CISCO CATALYST 6500.



nationals have been delivering outstanding financial results. Of the dozen companies *BusinessWeek* studied, the average revenue increase last year was 25.4%, vs. a 4% decline for the overall tech industry, says market researcher IDC.

These companies use geo-diversity to great advantage. Logitech, for instance, has placed its manufacturing headquarters in Taiwan to capitalize on low-cost Asian manufacturing. Meanwhile, its business-development headquarters in Europe has lined up strategic partnerships that have kept the company at the cutting edge of peripherals design, particularly for optical pens and mice. That has helped Logitech hold its own against mighty Microsoft in worldwide markets for peripherals.

For Wipro Ltd., there are clear pluses to locating sales in the U.S. and en-

E-WORLD To help deal with gaps between time zones and cultures, transnationals communicate in real time over the Internet

gineering in India. Wipro's vice-chairman, Vivek Paul, is based in Silicon Valley to be close to the mammoth U.S. market. At the same time, the company can underprice Western rivals because 17,000 of its 20,000 software engineers and consultants are in India, where the annual cost per employee is less than one-fifth that of Silicon Valley.

There are even some unintended benefits from operating transnationally. To collaborate smoothly in spite of the geographic barriers, all of the Wipro man-

agers file electronic activity reports with their superiors on Monday, who in turn pass them along, via e-mail, until summaries reach Paul, who travels nearly constantly. Not only does Paul stay plugged in wherever he is, but the report process "steps up the pace of the organization," he says.

This next big step in globalization won't be steady—or fast. Expect startups to experiment with new ways of operating, and a few innovative established companies to tinker with their geographic organizations. But being transnational requires fundamental and difficult shifts for the giants that might not be worth the trouble. Often, the transformation requires a unique leader—and extremely flexible business unit managers. Still, given the necessity to exploit new markets and to operate ever more efficiently, the pressure won't let up to create something approaching a corporation without a country.

*By Steve Hamm
in New York*

COGNOS

The Canadian/American company's international orientation has changed the way it makes software. In the past, it released different versions for each country. This month it will ship business software, designed for multinational customers, that includes all of the major languages, plus data on local currencies and tax regulations.

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INNOVATION

REINVENTING CORPORATE R&D

Now even companies with big research budgets don't try to invent everything in-house

Every month at Merck & Co., groups of scientists in different areas of disease research gather to evaluate the latest breakthroughs. But the innovations they haggle over don't come from Merck's own laboratories. They're generated someplace, anyplace, else: journals, conference reports, patent literature, and visits to other labs. "We scour the world," says Merv Turner, Merck's senior vice-president for external research.

At the end of the meetings, each group typically flags a couple of innovations for a small team of scientists to investigate. Last year, one of the brain trusts tagged Amrad Corp., a tiny Australian biotech company that's working on a promising drug to treat respiratory

diseases. By June, Merck had ponied up \$5 million to seal an exclusive license and a multiyear research collaboration with Amrad that one day could be worth \$112 million. It's just one payoff from Merck's "very aggressive antenna function to survey what's going on in the outside world," Turner says.

Welcome to the future of corporate research. In recent years, there has been much hand-wringing over the slowdown in industrial spending by America's big corporate labs. Legendary science and engineering bastions such as Xerox Corp.'s Palo Alto Research Center and the old AT&T Bell Labs have gone through painful pruning. And for the first time in more than a decade, there could be an actual decline in overall corporate research and development

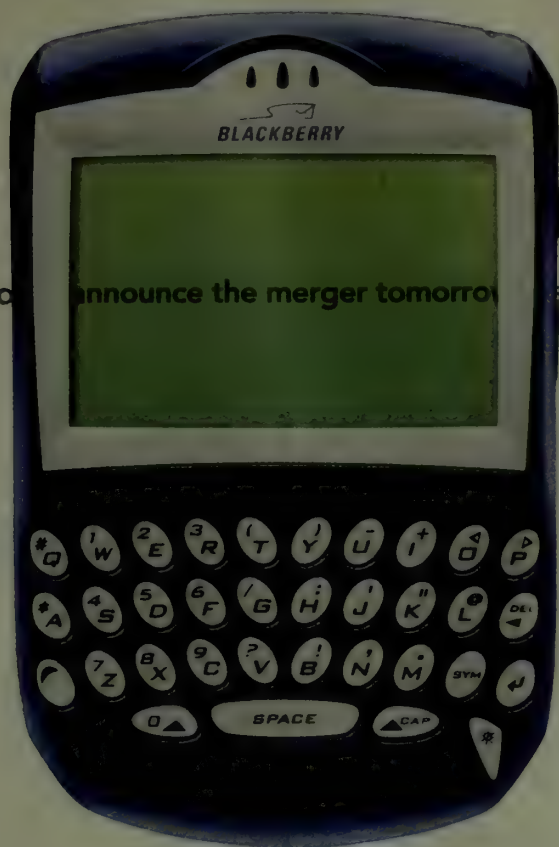
funding—\$192 billion for 2003, or 0.7% less than 2002, notes F.M. Ross Armbrrecht Jr., president of Industrial Research Institute Inc.

Rather than drying up, however, industrial research is bubbling up all over the place, with more big companies following Merck. The downsizing by industrial giants makes headlines. But at the same time, a new R&D model is emerging, dubbed open innovation. Companies of all sizes are rounding up more partners, big and small, than ever before, and they're casting wide research nets, snapping up work at diverse corporate, government, and academic labs.

So despite the gloomy dollar-spending numbers, U.S. R&D may be heading for a healthy makeover. While big companies have been a source of major breakthroughs, small and midsize companies have always been the main font of new products. Today, they're more innovative than ever—not least because the rapid growth of computer power has put unprecedented research resources in the hands of thousands of teams around the globe.

Furthermore, scientists everywhere are increasingly motivated by commercial payoffs. As a result, the time between new discoveries and product roll-outs is collapsing. "Fundamental science

GIANT SUCKING SOUND One worry: Many research jobs could go offshore



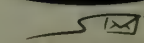
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SCOUTING FOR TECH Amid faster product rollouts, even powerhouses like P&G have to look outside for innovation

breakthroughs now have fairly rapid commercial applications," says Walter W. "Woody" Powell, a guru in organizational behavior at Stanford University. Meanwhile, industry-university consortiums are spinning off engineering startups at a quicker pace than ever before, says J. David Roessner, associate director of the Science & Technology Policy Program at SRI International.

At the same time, big companies are becoming more inventive in tapping researchers employed elsewhere to solve vexing problems. Giant chemical companies such as Dow Chemical Co. and BASF are posting research problems at a Web site run by Eli Lilly & Co.'s InnoCentive Inc., which tries to match scientists with research problems. Even Xerox, which set the standard for do-it-yourself research, has turned to outsiders to help develop optical-network technology. "We were definitely not doing that 20 years ago," says Herve Gallaire, Xerox' chief technology officer. Xerox has contributed its expertise in imaging technology to a joint project with Intel Corp. that produced Intel's latest microprocessor, announced Sept. 10. It's tailored for applications in document imaging.

Chalk it up mainly to corporate heavyweights learning that they can't develop all the breakthroughs in-house. "It's very hard for any company, even one that spends as much as we do on R&D, to do everything," says Paul Horn, senior vice-president and director of research at IBM, which last year spent \$4.8 billion on research.

In high tech, belt-tightening also is pushing companies to find cheaper alternatives to conventional research. A study last year by Massachusetts Institute of Technology's *Technology Review* magazine found that most leading companies in struggling industries—aerospace, computers, semiconductors, and telecommunications—had trimmed R&D outlays. But they haven't turned their backs on innovation; they've just farmed it out. "It's not necessary for companies to invest in basic research to make money from it," says Henry W. Chesbrough, a Harvard Business School professor and author of *Open Innovation*, widely cited by research execs such as Xerox' Gallaire and IBM's Horn.

Is there a danger in corporations relying too much on outside help? Merrilea J. Mayo, director of the Government-

University-Industry Research Roundtable at the National Academy of Sciences, is worried because so much research is moving offshore. American innovativeness, she warns, could be hobbled more by loss of higher-skill jobs than by those lost in NAFTA. "That 'giant sucking sound' that Ross Perot heard is now happening in R&D," Mayo says.

Nobody disputes that basic research in industry is taking its licks. Major scientific breakthroughs come mainly from long-term, well-funded R&D programs.

DISTRIBUTED INNOVATION

Few companies can meet all their research goals alone. So the smart ones are adopting an "open" research model that allows them to pool some assets. Here's what that entails:

SCOURING THE GLOBE for useful innovations, rather than trying to invent everything in-house

LICENSING INTELLECTUAL PROPERTY to other companies—in part to pay for outside research

FORGING TIES WITH UNIVERSITY LABS even if this means sharing prized intellectual-property rights

COURTING VENTURE-CAPITAL FUNDING and welcoming the discipline VCs impose

ENCOURAGING SPIN-OFFS that will pursue novel ideas and take risks

Data: Henry W. Chesbrough's *Open Innovation*, BusinessWeek

Companies that don't spend on basic research now may suffer later. "You have a bunch of people with stunted vision," says Nathan Myhrvold, Microsoft Corp.'s former chief technology officer.

The challenge, then, is to find the optimum balance of research and development. Procter & Gamble Co. thrived for years relying on the 7,500 employees in its R&D group to gin up new products. But as the pace of innovation elsewhere increased, P&G faltered. To fix the problem, CEO Alan G. Lafley has decreed that half of the company's ideas must come from outside, up from about 10% when he took over in 2000. "We are probably as good as the next guy in inventing," Lafley says. "But we are not absolutely and positively better than everybody else." Today, P&G has 53

"technology scouts" who search beyond company walls for promising innovations.

Other companies are scouting Web-based research services for talent. A year ago, Dow Chemical's Dow AgroSciences unit turned to Lilly's InnoCentive Web site to solve a dozen research riddles. InnoCentive has signed up 30,000 scientists worldwide and pays bounties of up to \$100,000 for solutions to problems posted on the site by Dow and other seekers. Dow just made its first payout—\$50,000. It was a bargain, says Mark W. Zettler,

manager of new-product development for Dow AgroSciences. Besides, he adds, "I would rather find the person who has the answer today than somebody that needs to work for three to six months in our lab." Since it was launched in mid-2001, InnoCentive has paid out roughly \$500,000 to its problem-solvers.

Another way to optimize research: Be more innovative in cozying up to universities. Intel is pioneering a new approach. It has set up satellite research facilities adjacent to Carnegie Mellon University, University of California at Berkeley, University of Washington, and Britain's Cambridge University. The idea is to move the brightest minds in academia temporarily into these "tablets" and focus on long-term projects. "We're only going to create a small fraction of the good

ideas, and only a small fraction are going to pass through our labs unless we take extra strong action," explains David L. Tennenhouse, Intel's director of research.

Ultimately, when the corporate R&D makeover is finished, U.S. industry may be in its best fighting trim ever. America was the innovation champ long before companies started splurging on basic research in the postwar era. Recent cutbacks in corporate funding of research are disturbing to many scientists. But the vibrant, open model now taking shape will make the U.S. "tremendously productive," says IBM's Horn. As long as large companies don't forsake the quest for the next big thing.

By Jay Greene in Seattle, with John Carey in Washington, Michael Arndt in Chicago, and Otis Port in New York

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OPTIMIZING TODAY'S TALENT MANAGEMENT STRATEGIES

FOCUS ON; EXECUTIVE ASSESSMENT



By

Judy Klein

Managing Partner

and

Stephen A. Miles

Principal

Heidrick & Struggles

Nearly everything about business seemed easier during the boom years of the late 1990s, including talent management. Strong results made every hire seem like a great hire, and in the glow of the bull market, every mid-level executive looked like CEO material.

Welcome back to reality.

Today's challenging business environment is a stark reminder to corporate leaders that talent management, wherein employees' skills and personalities are appropriately deployed to optimize performance, is a critical and difficult task. Furthermore, identifying and developing executives who have leadership potential, like every other vital strategic function, is a demanding process that is equal parts art and science. But now more than ever, businesses rise or fall on the strength of their people. And the onus to build and nurture this strength is on Boards of Directors and senior-level management.

To carry out this mission well is to fully appreciate the wide range of competencies necessary to have effective leadership teams that can withstand the test of time and market ups and downs. Operating excellence, technical competence, marketing savvy, passion, energy and drive are always important, but today's knowledge- and talent-intensive organizations also require the "soft" people skills that facilitate execution across functions, departments, regions, and operating units.

UNDERSTANDING AND IMPLEMENTING TALENT STRATEGIES

Understanding the importance of all these skills is one thing; being able to put this understanding into practice is another. How many corporate leaders today can say with con-

Whether it is the assessment and development of existing management or the acquisition of new talent, Heidrick & Struggles can be your partner in creating and optimizing the proper talent management strategy for your organization.

fidence that their management cadre has the complete package of skills to take the company forward? How many are certain that their executives are deployed where and when they can put their specific talents to the best and highest strategic use? And when a leadership need arises, how many can accurately discern whether it's time to promote an individual or if that executive needs further development? Until they gain strong insight into the talent in place within their organizations, senior managers are essentially

flying blind when it comes to talent strategy, whether the task is to determine current needs or to prepare for tomorrow's management challenges through succession planning.

Compounding the difficulty is the sheer size and complexity of many contemporary business organizations, which make it no simple undertaking to gather the information that will enable senior leadership to craft a winning talent strategy. And without robust information and analysis, leaders have little basis for deciding when and who to develop internally.

EXECUTIVE ASSESSMENTS: A STRATEGIC TOOL

One information-gathering tool that many corporate leaders are finding useful is the executive assessment, which evaluates and measures an organization's management talent in three key dimensions: against the organization's current and future strategic needs; against the competition; and against the overall talent marketplace. Properly performed, such assessments can help form the foundation of a winning talent strategy. They can produce the information that corporate leaders need to put the right people in the right positions at the right time, and they invariably clarify the processes that

monitor performance and develop capabilities. Corporations can use executive assessments to build a database to model the skills and competencies that their business strategies demand, and to help them determine whether they have talent in-house to match their needs and the level of professional development that may be needed. Assessments also allow companies to maximize the value of executive education programs, creating custom-fit learning strategies for their next generation of corporate leaders.

Most importantly, by partnering with a third-party expert to conduct executive assessments, senior managers can counteract the "in-house" bias that all too often leads to sub-optimal decision making. By approaching talent management in this manner, companies can better target retention, career development, and succession planning efforts on their stars of the future.

Heidrick & Struggles is one of the world's foremost proponents of executive assessments and has developed an industry-leading methodology. Our objective appraisal of a company's management team begins with a consultative review with the client to determine current and future leadership needs based on the strategic goals for the organization. Executives to be assessed are identified, informed and scheduled for their in-depth and structured competency-based interview conducted by consultants who have been rigorously trained and have assessed many executives in the client company's industry or functional area. Using a highly specialized framework, we can accurately assess an executive's ability to learn, think creatively, envision, engage and execute - the competencies most closely linked to optimum performance. Interview results are combined with feedback from professional and objective 360-degree referencing - including customers and other key constituents - again conducted by experienced consultants. The outcome is a meaningful evaluation of competencies, strengths, and areas for professional development.

Executive assessments yield a rich trove of information that companies can put to work in a variety of ways. They can

Our objective appraisal of a company's management team begins with a consultative review with the client to determine current and future leadership needs based on the strategic goals for the organization.

be especially useful in developing the capabilities of less experienced executives who may have earned their positions on the virtues of long hours, specialized expertise, and individual accomplishment. For all their talent and promise, many high achievers lack the softer skills required in leaders of contemporary corporations. Their communications, change management, people and persuasion skills may need development. They know how to drive themselves hard in pursuit of a goal, but may have insufficient experience motivating and guiding teams. They may not have been able to take the time to cultivate the relationships needed to manage large, complex organizations, nor develop skills that keep a bewildering array of stakeholders confident in the future of the company. And their very ability to focus on discrete elements of the business may have inhibited their ability to think across the enterprise.

Therefore, assessments enable boards and/or senior management to intervene in promising careers and craft development plans that address both the

needs of the executive and of the company. Heidrick & Struggles, through our affiliation with Lore International Institute, a premier provider of leadership development programs, can assist in crafting such plans with specific recommendations on retention, professional development, executive coaching and executive education.

USING TALENT STRATEGIES AS A CHANGE AGENT

In the 21st century, organizations will not survive, much less grow, unless they evolve from a collection of insular, isolated business units into cooperative, collaborative, synchronized enterprises. Such massive change efforts require new skills and competencies of their leaders, yes, but also something more. Change demands a new vision of the organization, one that recognizes talent as a vital component of strategy, on an equal footing with technology, finance, and marketing.

Talent management takes on a new dimension in today's competitive marketplace. It requires an understanding of corporate strategic goals and of the role that talent plays in reaching them. And it requires a nimble organization with the expertise and resources to identify talent needs and quickly decide whether to meet them from within or draw them from outside. Indeed, it is not an exaggeration to say that the future belongs to businesses that can weave talent and strategy into a seamless whole, and in the process build an organization with not only optimized performance but also with a significant competitive advantage as well.



Heidrick & Struggles International, Inc. is the world's premier provider of executive search and leadership consulting services. Currently, approximately 1,300 Heidrick & Struggles search professionals and employees operate from locations primarily in North America, Latin America, Europe, and Asia Pacific. For 50 years, Heidrick & Struggles has specialized in chief executive, board member and senior-level management search assignments for a broad spectrum of clients: multi-national corporations, mid-cap and start-up companies, nonprofit entities, educational institutions, foundations, associations and governmental units. The company is expanding its range of complementary services to offer solutions to senior management teams for their leadership needs, including recruitment of emerging talent, executive assessment, interim executive placement, and professional development.

Judy Klein is a Managing Partner for the firm's Cleveland office. Stephen Miles is a Principal in the firm's Leadership Services business. Both conduct executive assessments for clients operating in the industrial, technology, financial services, consumer, and healthcare industries. For more information, email Judy at JKlein@heidrick.com or Stephen at SMiles@heidrick.com.

For more information about Heidrick & Struggles, visit www.heidrick.com or email CEO@heidrick.com.

REFORM: WHO'S MAKING THE GRADE

A performance review for CEOs, boards, analysts, and others

On a humid morning in late July, lawmakers, regulators, reporters, and half a dozen TV crews crowded into the usually ample William O. Douglas room in the basement of the Securities & Exchange Commission in Washington. The mood was jovial, the speeches full of backslapping and congratulations. Republicans paid tribute to Democrats, Democrats applauded Republicans. It was the first anniversary of the signing of the Sarbanes-Oxley Act, the most sweeping overhaul of corporate securities law in 70 years. "This is truly a moment of celebration," gushed Senator Christopher J. Dodd (D-Conn.), the last of four sponsoring legislators to take a turn at the microphone.

There is no doubt that SarbOx had given reformers a powerful tool to scrub down and reengineer the American system of running and evaluating corporations. In the two years since energy trader Enron Corp. went belly-up—revealing a morass of mismanagement and accounting abuse—regulators, prosecutors, and Congress have tripped over one another in a push for punishment. Companies, meanwhile, have spent at least \$1 billion adopting new Sarbanes-Oxley rules meant to address the crisis of confidence that wiped out \$35 billion in investor wealth. Corporate audit committees are gathering more often for longer meetings and asking tougher questions. Auditors are for the first time bowing to the rules of a regulator. Bad analysts are being fined millions of dollars. A few rogue executives are even standing criminal trial.

But hold the applause. For all their apparent victories, there is still an awful lot yet to be done. The Justice Dept. has been pounded for its failure to indict the CEOs involved in the very largest

meltdowns, such as Enron's Jeffrey K. Skilling and WorldCom's Bernard J. Ebbers. Even more troubling are the other players, including investors, boards, and CEOs, without whom any hope for permanent change is doubtful. As a group, their performance so far has been disappointing. Boards have yet to rein in executive pay, with one of the most shocking payouts—almost \$140 million—going to a regulator, Richard

A. Grasso of the New York Stock Exchange. Most upsetting is a sense that the scandals continue apace: Freddie Mac's ex-CEO Leland C. Brendsel was accused this summer by the company's board of smoothing earnings to boost future performance. (Even so, they agreed to honor his parting package of \$54 million.)

On the corporate front, many CEOs and CFOs have begun to exhibit acute



REGULATORS

REPORT CARD

A-

Quick to put new governance rules into place... Launched high-impact investigations into executive-pay abuse (Tyco), fraudulent accounting (WorldCom), and conflict of interest (Wall Street)

WHAT'S NEEDED

Tougher enforcement, particularly prosecution of the worst governance and accounting offenders



SINCE DONALDSON TOOK OVER, THE SEC HAS GOTTEN TOUGHER

reform fatigue. They argue that the new rules have gone too far, that they are stifling risk-taking, and that companies have been saddled with broader and more expensive audits and higher bills for insuring officers and boards. A recent PricewaterhouseCoopers survey found that the number of executives with a favorable opinion of Sarbanes-Oxley had fallen from 42% last October to 30% this June.

At companies where the tougher reviews have not turned up new problems, CEOs are already questioning the cost. "We have upwards of \$6 billion in sales [and] earnings last year of well over \$500 million, and our auditors are spending a lot of time documenting items that would be in the several-hundred-thousand-dollar area," complains Stephen L. Baum, CEO of Sempra Energy, which has spent more than \$1 million on Sarbanes-Oxley requirements. Are CEOs merely impatient with seemingly petty restrictions or, as some worry, is there a deeper rejection of the corporate cleanup? Says Christopher Davis, portfolio manager at Davis Advisors, which oversees \$25 billion in mutual funds: "There is a sense that if the capital markets simply recover and the stock market goes up,

this whole focus on governance will lose steam."

That makes this a critical juncture in the time line of reform. As with any hastily drafted legislation, Sarbanes-Oxley isn't perfect. The only chance to avoid backsliding too far, however, is if regulators, auditors, and investors keep the heat on. "What is needed now is ongoing and permanent enforcement and monitoring," says New York State Comptroller Alan G. Hevesi, who's trying to get institutional investors to form a watchdog group. Here's *BusinessWeek's* report card on how the key players in corporate reform are measuring up:

REGULATORS

Luckily for investors, there is a mosaic of enforcers in high gear today with zealous federal, state, and local agencies wrestling one another for the mantle of reform. Investigations by New York State Attorney General Eliot Spitzer have brought to light shocking conflicts of interest at mutual funds and invest-

**Says one adviser:
"There is a sense
that if [markets]
simply recover...
this whole focus
on governance
will lose steam"**

ment banks, and at a much brisker pace than the usual regulatory trudge. New York City District Attorney Robert M. Morgenthau is bringing Tyco's L. Dennis Kozlowski to trial on Sept. 29. In Alabama, U.S. Attorney Alice H. Martin has gotten 14 plea bargains as she storms through a HealthSouth investigation.

But at the SEC—the pivotal regulatory agency—progress has been

halting. Last fall, besieged by allegations of favoritism toward the accounting industry by then-Chairman Harvey L. Pitt, the commission was looking like an agency in need of its own overhaul.

The SEC's performance has improved since former Wall Street leader William H. Donaldson finally took over in February. The agency completed its Sarbanes-Oxley rule making, including new requirements that CEOs must attest to the validity of financial statements and disclose off-balance-sheet transactions. It also launched the Public Company Accounting Oversight Board to watch over auditors, and it embarked on a number of new investigations into corporate wrongdoing. "I do think there has been a gradual recognition that the policeman is on the beat," says Donaldson. He's even contemplating reforms that go beyond the law, including allowing investors to nominate candidates for boards of directors.

Still, in one vital area—enforcement—the commission's grade is, at best, an incomplete. In the past 23 months, the SEC has filed 1,141 enforcement actions, compared with 987 in 2000-01. But the SEC has frequently followed its traditional path of allowing individuals and companies to settle charges with a fine, without admitting guilt. The Justice Dept. has also come in for some criticism that it is acting too slowly. Notwithstanding all the executives accused of wrongdoing at Enron, WorldCom, Tyco International, Adelphia, Xerox, and HealthSouth, only one CEO, ImClone Systems' Samuel Waksal, has been convicted and sentenced to jail.

"Until you see people paying for this behavior, the jury's still out on reform," says John Keogh, president of National Union, the directors and officers insurance company.

CEOs

Corporate chiefs have remained too quiet, reacting to and even resisting the drive for reform rather than leading it. The number of companies fighting to



CEOs

REPORT CARD

Far too much ducking for cover by a group that is still paid astronomical sums.... Lobbying hard against certain reforms including expensing stock options

NEEDS WORK

Attitude—even at companies whose history is squeaky clean, it's important to take the lead on reform

**BRENDSEL:
QUESTIONABLE
ACCOUNTING AT
FREDDIE MAC?**

keep shareholder resolutions off their proxies skyrocketed this year. And last month, Pfizer Inc. CEO Henry A. McKinnell wrote to the SEC on behalf of the Business Roundtable opposing proposals to democratize board nominations.

While a few managers have taken steps to improve disclosure beyond SEC requirements, many chief executives ignore easy improvements. Jeffrey Rodek, CEO of Hyperion Solutions Corp., which makes financial software, notes that fewer than half of the 100 largest companies issue a quarterly cash-flow statement at the same time as income statement and balance sheet, even though cash is an important check on the trustworthiness of the other numbers. Even boards aren't satisfied with their company's disclosure. A recent Hyperion poll of 150 board members found that nearly 40% felt their management was not telling them enough about operations. Some 65% were not satisfied with the accuracy of the forecasts they were getting.

Particularly galling is that it's still standard practice for companies to buy indemnity policies that pay the legal costs of CEOs. Exhibit A: John J. Rigas, accused of using cable company Adelphia Communications Corp. as his personal piggy bank, is pressuring the company's insurer to cover his legal costs.

INVESTORS

By all rights, institutional investors should have been charging angrily to the front lines in the battle for corporate reform. They control more than half of U.S. investing dollars, and their clients, the individuals and corporations who entrusted them to manage mutual-fund and pension assets, were the primary victims of the accounting and compensation scandals. Plunging market values even cut into their own fee income and reputations.

There was hope early on that investors might take up arms. Last year, money manager Davis, who represents the third generation in family-run Davis Advisors, set out to organize a group of leading insti-

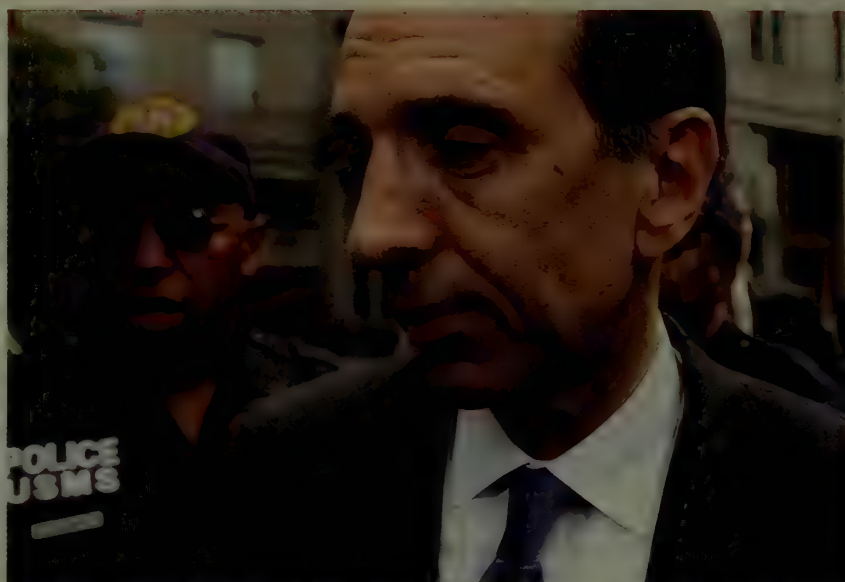
tutional investors who would together press corporate directors and executives for clean accounting, good audits, and compensation tied strictly to performance. He held an initial meeting in April, 2002, that attracted more than a dozen industry leaders, including Legg Mason Funds Management Inc.'s Bill Miller. Meanwhile, John C. Bogle, the founder and former CEO of Vanguard Group Inc., was trying to form the Federation of Long-Term Investors.

money managers also manage pension accounts for the big companies they invest in, making it awkward to criticize management. Fund-industry leaders at Fidelity Investments and the Investment Company Institute have also fought moves to force them to disclose their votes on corporate proxies. "Instead of putting the owners first," says Bogle, "we're putting management first." As the owners of these companies, investors have the heaviest hammer, and they should use it.

ANALYSTS

There's no doubt Wall Street research analysts are feeling the heat of reform. Internal SWAT teams are combing through analysts' e-mail. "Chaperons" are listening in on their phone conversations. Ratings changes are being scrutinized by extra layers of bureaucracy. One analyst, concerned about getting caught in the ethics crossfire, even asked a research director whether an analyst would have to leave a dinner party if an investment banker were there.

The brokerage houses that signed the \$1.4 billion research settlement are following the new rules to the letter, but it's less certain that they've corrected the core problem: putting out better research. Today, major firms cover less of the market—only 23,000 companies, compared with 28,500 just three years ago, according to Thomson First Call. But roughly one-third of the research departments of the big firms have been laid off, and those who survived the shakeout are being asked to cover more companies with increased ac-



WAKSAL: The only exec to draw jail time so far



INVESTORS

REPORT CARD

Slow to demand governance reforms, fought movement to release votes on important corporate issues

NEEDS WORK Monitoring the boards and management they invest with, dealing with conflicts of holding stock in a company whose pension fund they would like to manage



ANALYSTS

REPORT CARD

Made progress on building a wall between investment banking and research, and injecting skepticism into company analysis

NEEDS WORK Forging an effective new form of research and getting more research into investors' hands, a provision of the global settlement that's largely unmet



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curacy for less pay. On average, a senior analyst is now expected to cover nine companies instead of six. One element of the settlement—that banks distribute independent research to balance their own—has yet to be fully put in place.

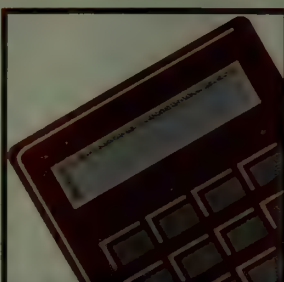
On the whole, analysts seem to be taking a more skeptical look at the companies they analyze. In the late 1990s, about 67% of all analyst recommendations were "buys," and 1% were "sells." Now, only 41.7% of recommendations are buys and 10.5% are sells. But not everyone seems to have gotten religion. Despite its ad campaign claiming it was one of the few honest researchers around, Prudential Securities Inc. had sell ratings on only 3% of its companies on Aug. 25. That's far below Morgan Stanley, Goldman Sachs, and Salomon Smith Barney, which have sell ratings on more than 15% of the companies they cover. Prudential says the 3% reflected their belief that the market would climb. "They [Prudential] haven't changed their spots," worries Charles L. Hill, veteran research director at First Call.

To prove they deserve their role, analysts must follow the lead of those firms working to force a more effective new form of research. At Merrill Lynch & Co. and Credit Suisse First Boston, analysts are increasingly working in teams that mix bond and stock specialists and that mix analysts who cover suppliers with those who watch their customers. This approach is designed to avoid situations like Enron, where the skepticism of bond watchers was ignored by equity analysts.

AUDITORS

Accountants are climbing out of the mud. After the collapse of Arthur Andersen and a string of billion-dollar accounting breakdowns, auditors were derided as rubber stamps for management, a group that seemed more concerned with milking clients for consulting fees than truly auditing them.

But things are looking up. Auditors seem to be pushing for more financial restatements: Some 158 companies took



AUDITORS

REPORT CARD

Efforts to comply with Sarbanes-Oxley and go beyond that to even deeper reform have helped the big firms rehabilitate a badly tarnished image

B-

NEEDS WORK

Must show that they will continue to force companies to comply with proper accounting, even after the focus on reform dies down, and won't try to co-opt their new regulators

their industry. They took a hard look at why—and wound up resigning from more than 70 of the accounts in question.

Determining how truly auditors have reformed falls to the newly minted Public Company Accounting Oversight Board, a creation of Sarbanes-Oxley. The four largest firms are already undergoing inspection. "They are saying the right things. What our inspections will indicate is whether they are also doing the right things," says William J. McDonough, the board's new chairman.

BOARDS

These days, when an insurance company meets with a director or a corporate executive to discuss directors' and officers' insurance, the hot topic is compensation—what kind of perks

that step in the first half of 2003, well above the first half of 2002. Certainly some of these are corrections of the often-costly errors of the past, but there is some reason to hope the new toughness is serious. At Freddie Mac, it was auditor PricewaterhouseCoopers that raised questions about the earnings-smoothing being led by then-CEO Brendsel. Whether it was out of fear of going the way of Arthur Andersen or a true commitment to change, the major firms have themselves gone well beyond SarbOx to rethink their business in more fundamental ways. At KPMG, the auditors are now reviewed not only by their boss, who focuses on business growth, but also by risk experts, who rate how well the accountant complied with the firm's rules. At Deloitte & Touche, the partners identified 400 audit clients that appeared to be performing far better or far worse than

executives get, the loans extended to officers, compensation plans they took to shareholder vote, and how high a percentage they won by. Enough bad answers and an insurer will walk away, mostly for fear of litigation.

Despite plenty of evidence that chief executives didn't come close to earning the outsize paychecks they got during the days of the bull market, not to mention some apparent out-and-out looting, top managers are still getting top dollar. The average CEO made \$2.4 million in salary and bonus last year, compared with \$2.3 million the year before. And while CEO pay isn't growing as fast as it once did, it's still growing faster than pay for non-execs. Even once-burnt companies are going right along. Despite criticism of its generous exit package for William T. Esrey, for instance, Sprint Corp.'s board just gave his successor, Gary Forsee, a welcome-aboard gift of \$14.5 million in restricted stock and guaranteed bonus, on top of a \$1 million salary. Sprint says most of that award is stock tied to performance and doesn't vest until 2007.

But if boards get an F on pay, they make up ground in their other key role: overseeing the auditor. Board members say they're meeting more often and for longer periods, and auditors say they're asking tougher questions. They need to bring a similar discipline to compensation if they're to do a decent job as the first line against corporate backsliding.

How real is corporate reform? The test will come in the next bull market, when the temptation to cut corners will be back in force. "Just avoiding jail should not be the goal here," says William W. George, former CEO of Medtronic Inc. and a board member of Novartis, Goldman Sachs, and Target. "It should be building great companies." That will depend on whether these key groups have embraced the spirit of reform or just its letter.

By Nanette Byrnes, with David Henry and Emily Thornton in New York and Paula Dwyer in Washington



BOARDS

REPORT CARD

Meeting more often and becoming more independent...audit committees have particularly redoubled their efforts

NEEDS WORK

Compensation committees need to take control of executive-pay excesses and demand more pay be tied to specific performance metrics

C+

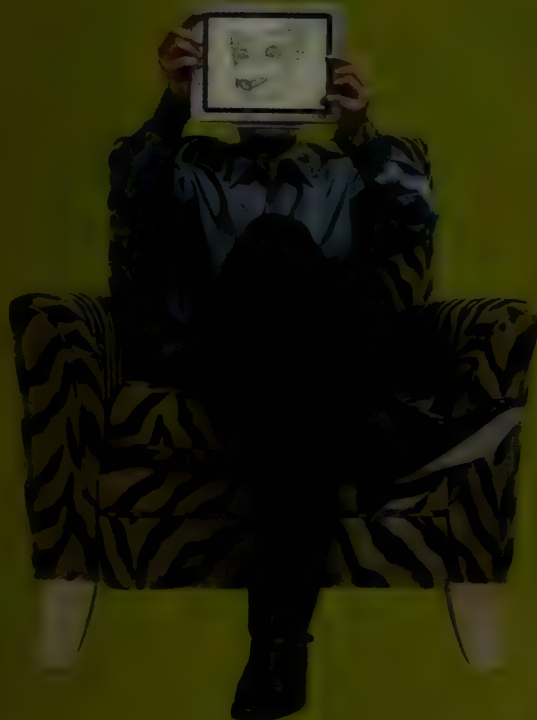


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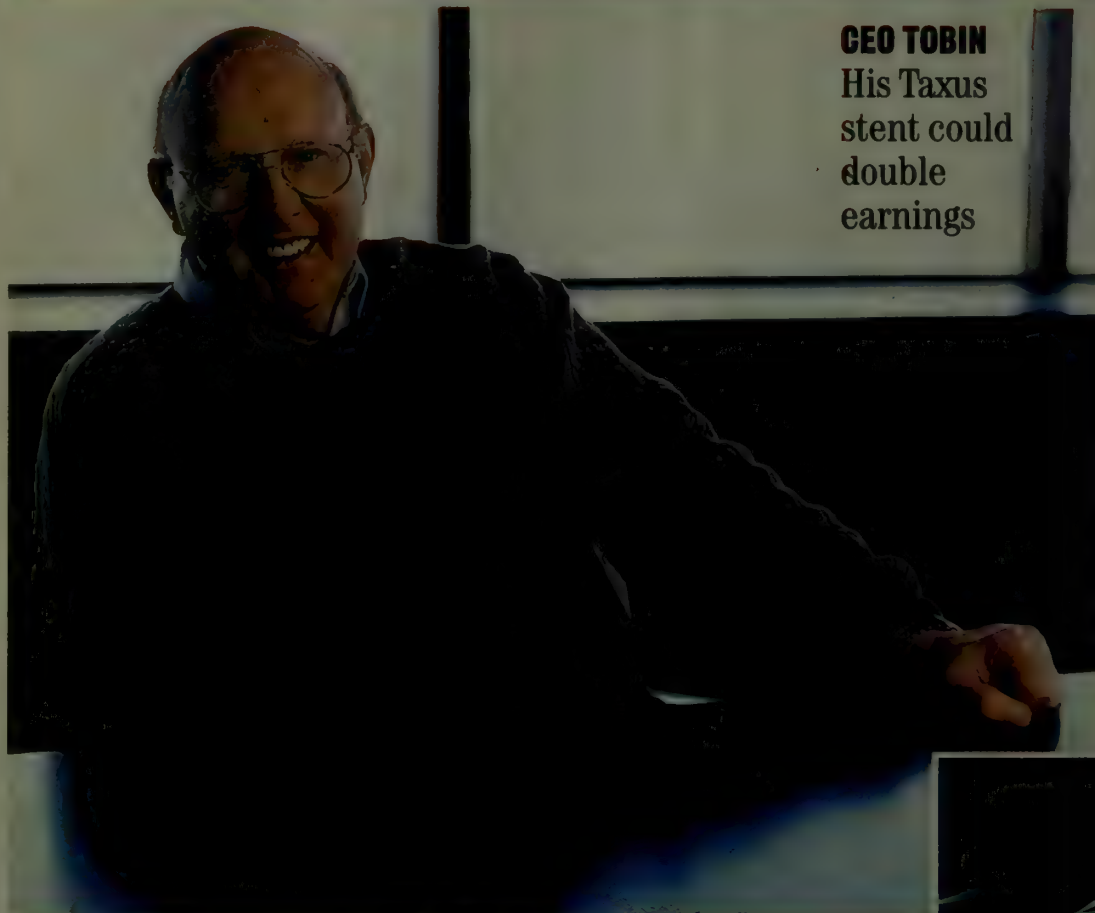
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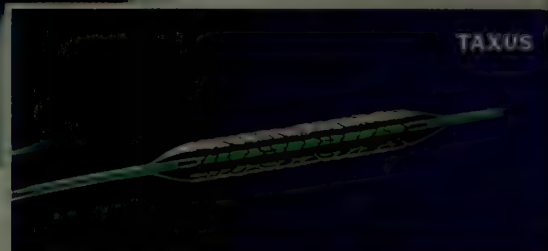
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CEO TOBIN His Taxus stent could double earnings

whose own stent, Cypher, holds about half of the market? Tobin's cheerleaders are betting on Taxus being cheaper, easier for doctors to use, and just as effective as Cypher. Boston Scientific may also tap into doctors' resentment of J&J, which priced its stent three times higher than previous versions and could not supply them fast enough to all the patients who needed them. J&J is now boosting supply and on Sept. 8 cut prices by about 10%.

Yet while the payoff is in sight, it is too early for Boston Scientific to start counting cash. Besides the challenge of launching Taxus, the company faces a slew of patent-infringement lawsuits, and at the same time is being investigated by the Justice Dept. over whether it violated FDA rules when it sup-



STRATEGIES

WHEN WILL THIS STENT SEE CIRCULATION?

Boston Scientific must clear the FDA, among other hurdles

James R. Tobin knew he was speaking to a skeptical crowd of analysts last January, but the CEO of Boston Scientific Corp. took the plunge anyway. He boldly predicted that his company could grab 75% of the \$5 billion coronary stent market—and trounce the mighty Johnson & Johnson in the process. The response? Snickers. After all, Boston Scientific then had just a 13% share. "Everybody thought we were the gang that can't shoot straight, that if we were lucky, we'd get 20% market share," recalls the 59-year-old Tobin. "I've never believed any of that."

Today, Wall Street's snickers have turned into applause. Boston Scientific, which last year sold \$3 billion worth of medical devices, such as catheters, coils, and sponges, has seen its stock price

rise 37% this year, to about \$59. Investors saw the new coronary stent, Taxus, perform strongly in Europe and move toward Food & Drug Administration approval early next year. Analysts now think the new device—a drug-coated metal tube about the size of the spring inside a ballpoint pen, which is inserted into blood vessels to treat coronary disease—could add \$2.5 billion in new revenues and more than double the company's earnings in 2004, to \$1.2 billion. And they think Taxus can back up Tobin's boast of grabbing the lion's share of the U.S. stent market. "This could be an extraordinary takeoff point for the company," says Merrill Lynch & Co. analyst Daniel Lemaitre.

How can Boston Scientific hope to beat J&J, a company 10 times its size

plied data for an earlier stent. And, of course, J&J will flex its muscles to stay ahead. It hopes to launch a better stent in the second half of 2004, and is planning head-to-head clinical trials between Cypher and Taxus. "We feel very confident of our position," says Bob Croce, president of Cordis, J&J's stent unit.

Just getting FDA approval for Taxus presents its own set of challenges. Boston Scientific has yet to learn if an expert panel will consider its application in October or at a later date, which could delay the stent's launch. It took J&J six months after its expert panel met to receive approval. There's no telling how long the process will take for Boston Scientific. On Sept. 15, the company was to reveal the clinical trial data it submitted to the FDA. Analysts believe that if Taxus keeps arteries from reclogging at least 88% of the time, it will prove the device's effectiveness. But unlike J&J, Boston Scientific doesn't have a drug partner to help respond to FDA queries. J&J's Cypher uses rapamycin, an immunosuppressant made by Wyeth. Taxus, by contrast, uses a generic cancer drug. So when FDA queries arise, it may take longer for Boston Scientific to reply.

Further resources could be drawn away by the patent-infringement law-

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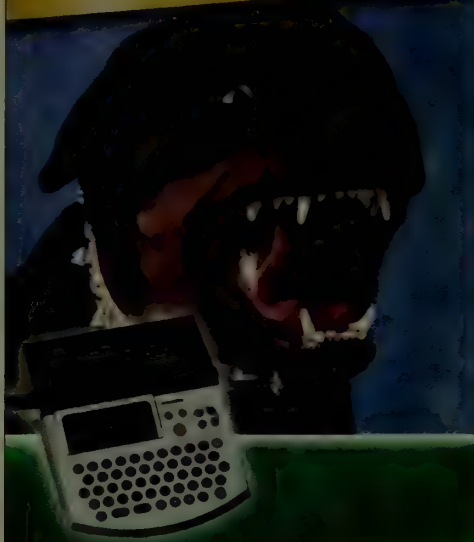
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suits filed by J&J, stent maker Medtronic, and Medinol Ltd., a former partner in making a stent. If Boston Scientific loses any of these complex cases—and some analysts don't discount that possibility—damages and royalties could total hundreds of millions of dollars. Tobin is combative about the claims that other companies own technologies behind Taxus, calling the suits “a sideshow.” “The [stent] is ours. We developed it from scratch,” he says.

The Justice Dept. probe doesn't directly involve Taxus but bears watching. Investigators are looking into whether Boston Scientific withheld data from the FDA for a stent it made with Medinol, which was recalled in 1998. The device was allegedly linked to one death and more than 20 injuries. Tobin acknowledges that the probe is picking up steam. He says his company is cooperating with Justice to extend the statute of limitations, which runs out at the end of 2003, so that it can finish investigating. The result could be criminal indictments.

Tobin had a cleanup job on his hands when he arrived in March, 1999. Boston Scientific, which began in 1979 by making catheters and angioplasty balloons, was smarting from the stent recall and an accounting scandal at its Japanese subsidiary. And after years of acquiring small device makers, it had no head of quality, clinical trials, or regulatory affairs. Tobin, former CEO of Biogen Inc. and a 22-year veteran of Baxter International Inc., fixed all that, better integrated the companies to achieve cost savings, and upped the research budget.

From that effort in the labs came Taxus, now going mano-a-mano with J&J. Price is a key consideration. In Europe, both stents have competed since February. J&J claims it has half the market, while Boston Scientific claims it holds two-thirds. Boston Scientific is undeniably winning the price war. Taxus goes for about \$1,800. J&J won't confirm a European price, but analysts say Cypher is priced 33% higher. Boston Scientific hasn't set a U.S. price. But analysts think Taxus will cost \$2,500 to \$2,750. Cypher lists for \$3,200, though J&J now says that discounts have driven the average cost down to \$2,600. Even so, J&J's new stent has sent some doctors into sticker shock—older, uncoated stents cost only \$1,000.

Johnson & Johnson also alienated doctors by not having enough stents on hand after Cypher was approved earlier

this year. The problem: It made too many stents too early. When the FDA O.K.'d Cypher, it mandated a shelf life of six months. Because J&J was counting on a year, much of its inventory had already expired. It had to toss thousands of stents and couldn't meet demand. “They made some doctors angry,” says Dr. S. Chiu Wong, director of the cardiac catheterization lab at New York-Presbyterian Hospital. “Supply was 35% to 40% of what we needed.” Boston Scientific claims that it can manufacture stents more quickly than J&J and will dodge that problem. J&J counters that it is ramping up production and will meet 80% of projected demand

NOT SO FAST

Before Boston Scientific can count on big sales from a new drug-coated stent, it has to overcome three key challenges:

REGULATORS

The FDA could still withhold or delay approval. A delayed launch could allow rival Johnson & Johnson to dominate the \$5 billion stent market.

INVESTIGATORS

The Justice Dept. is investigating problems with an earlier stent, which may have caused one death. The company might face criminal charges.

COURTS

J&J and others have sued Boston Scientific for patent infringement. A loss would subject Boston Scientific to millions in damages and royalty payments.

by yearend. That, it believes, will help heal relations with doctors. Says Crocco, “Is Boston the overwhelming favorite and we're the overwhelming underdog on a customer-relationship basis? I have a hard time with that one.”

Even if he grabs a lead, Tobin must know that the riches from Taxus will begin to diminish in 2006 as new competitors enter the market. So he is already prowling for more acquisitions. Boston Scientific may never again see a potential blockbuster like this stent. For Tobin, not looking for the next big thing doesn't seem to be an option.

By Faith Arner in Natick, Mass.

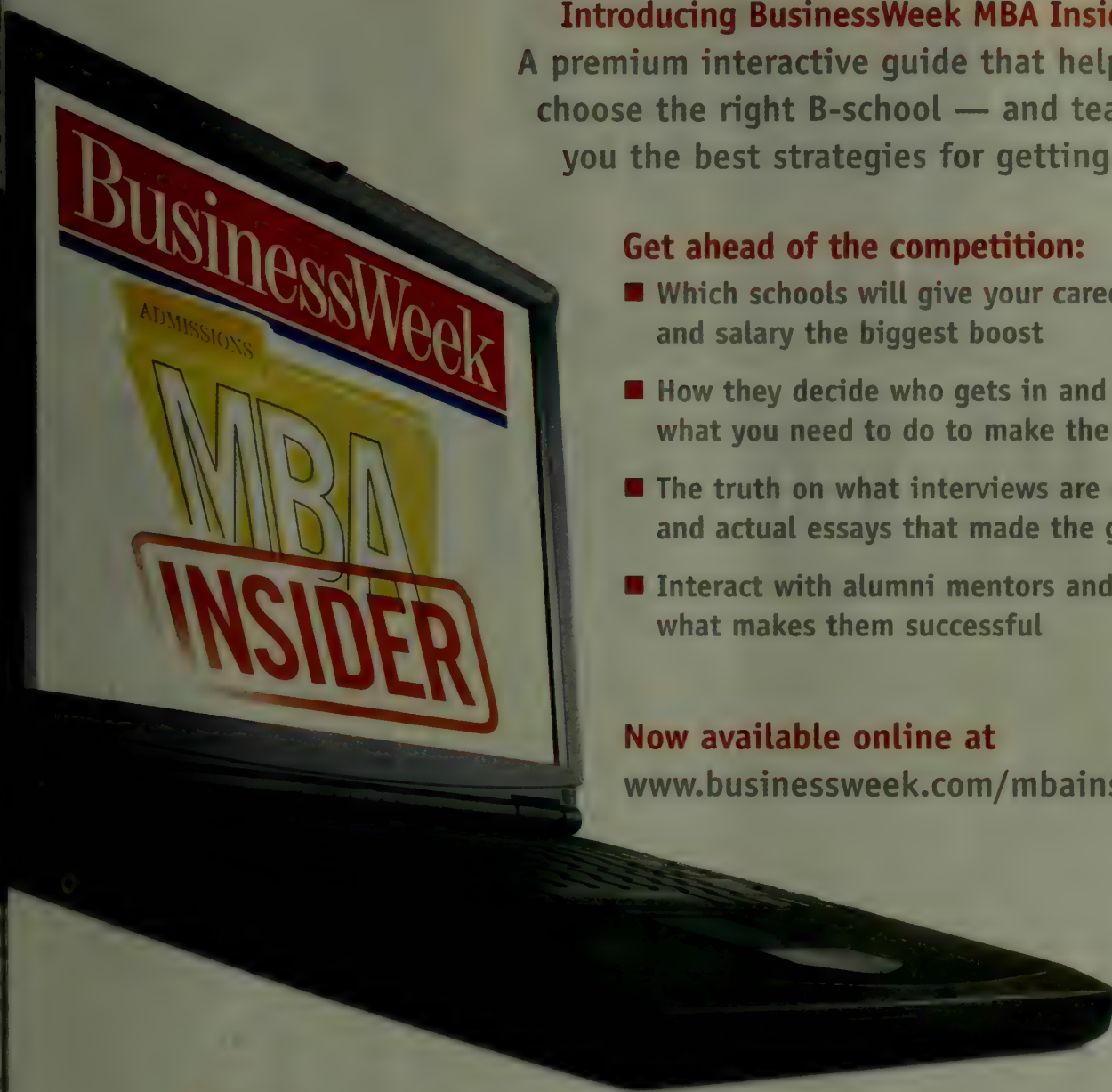
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WHAT'S AN MBA REALLY WORTH?

The class of '92 gives the degree high marks in our exclusive survey of B-school alums. **BY JENNIFER MERRITT**

Once the holy grail of business education, the MBA has become increasingly tarnished over the past two years. B-schools lack the academic depth of other graduate programs, some say. The MBA-wielding manager has little more to offer a company than those who rise up the ranks on merit, charge others. Another claim: A bunch of MBAs cooked up all those corporate shenanigans. The credential that came of age in the late 1980s and early 1990s as business became the "it" profession has been taking its lumps right along with Corporate America.

Then, last year, Stanford University Graduate School of Business Professor Jeffrey Pfeffer turned up the volume. Pfeffer took a shot at B-schools from inside the ivory tower

with his controversial paper, "The End of Business Schools? Less

Success Than Meets the Eye," published in the *Academy of Management, Learning & Education* journal. He argued that since there had never been a measure of the long-term value of the degree, there was no way to really know if a pricey B-school education—tuition and lost salary often top

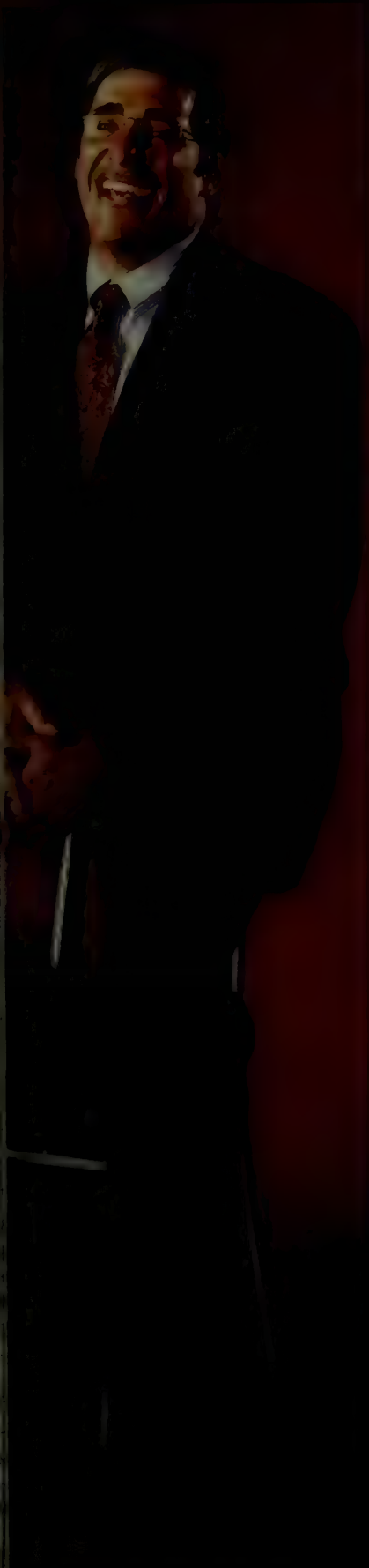
\$175,000—was worthwhile. And he posited that MBA holders seemed no more successful than persistent business leaders without the degree. "What matters over time is not where you come from or who you once knew. What matters is what you can do," says Pfeffer. The paper sent shivers down every dean's back and caused doomsayers to proclaim the MBA's ignominious end.

Well, hold on to your hat, Professor Pfeffer: The Class of 1992 gives B-school a big thumbs-up. In *BusinessWeek's* exclusive survey of MBA alumni, nearly 1,500 alums of the Class of 1992 from our Top 30 B-schools report high levels of satisfaction with their careers and say they owe much of that success to their MBA experience.

This spring, *BusinessWeek* set out to assess the impact of an MBA on grads who have had more than 10 years to test-drive their skills. The survey, developed by *BusinessWeek* and Boston-based Cambria Consulting Inc. (which has assisted the magazine with MBA, executive education, and executive MBA rankings since 1999), quantifies a mosaic of information, including averages, anecdotes, and interviews with dozens of survey respondents, B-school deans, corporate recruiters and other experts.

Rather than a ranking, the effort yields a portrait of the MBA's value as seen through the eyes of a group that gradu

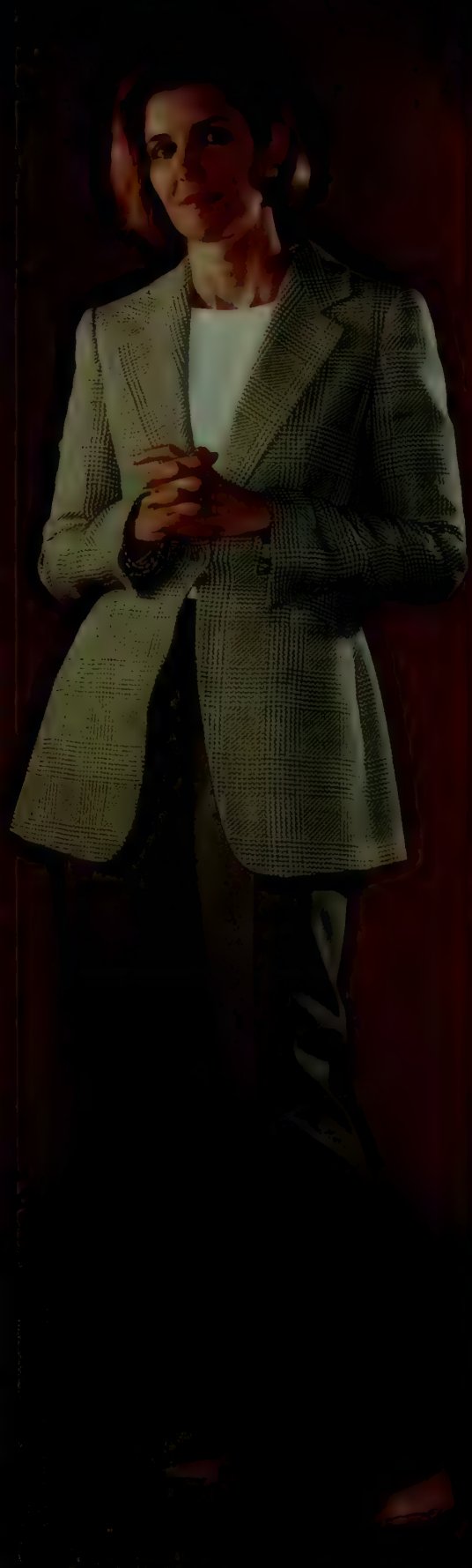
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THE PHILANTHROPIST

HARVARD

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a software company



THE WALL STREET STAR

COLUMBIA

Sallie L. Krawcheck, after
running Sanford C. Bernstein &
Co., was recently named CEO of
Citigroup's Smith Barney



THE HIGH-TECH HIGHFLIER

VIRGINIA

James M. Berger landed his
dream job in June as
vice-president of marketing
at GameSpy Industries

ated at a time when a business degree had become highly desirable. So what does that group have to say? That the MBA is worth a lot. Sure, it's not a perfect degree. It's not always good for all the things it sets out to teach. But in an increasingly credential-crazed society, it definitely opens doors—and graduates walk through them with a high level of confidence.

What's more, the data depict a managerial class that's in a truly commanding position. Their salaries and bonuses are hefty (page 96), and they occupy, after only a decade, top posts in their companies. They are an enterprising lot, an entire cohort of ambitious men and women who have started hundreds of companies and created nearly 100,000 jobs—a surprising record from a group often derided as better at bean-counting and consulting than actually doing anything. Today among the class are chief executive officers, vice-presidents, regional managers, and directors in nearly every corner of Corporate America. They're loaded with management responsibilities, overseeing an average of 93 people. And many have the

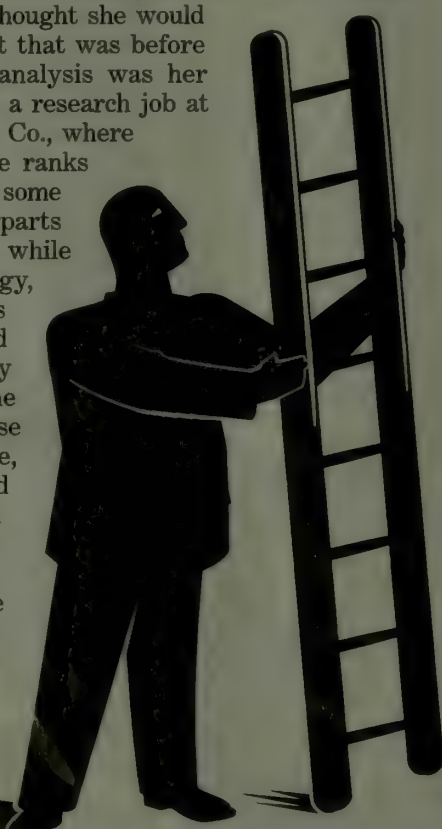
Cover Story

wealth and desire to give generously of their riches and time.

Overwhelmingly, they say earning the degree was worth it. Some 89% say they would go for the MBA again if they had it to do over. And nearly 80% said they would attend the same school. Those who said they wish they had gone elsewhere often cited schools like Stanford, Harvard, Kellogg, and Wharton as their dream choices—pointing to the enduring strength of those well-known brands. Alums largely gave the level of instruction and knowledge they gained from their own school high marks. "I look at what the B-school experience did for me, and I would have paid multiple times what I paid for the education," says 38-year-old Sallie L. Krawcheck, 1992 Columbia Business School grad and recently appointed chairman and CEO of Citigroup Inc.'s Smith Barney.

For Krawcheck and many others, the skills and knowledge kicked in not so much in the first job, but in the second or third. Krawcheck first thought she would be in the media biz, but that was before she realized research analysis was her natural talent. She took a research job at Sanford C. Bernstein & Co., where she quickly rose up the ranks to run the firm. In fact, some 22% of her '92 counterparts now work in banking, while 16% work in technology, 15% in consumer goods or manufacturing, and 12% in consulting. Many others are climbing the ladder in fields as diverse as education, health care, retail, banking, and biotech. About one-third occupy one of the top three slots in their company. Still others are running their own ship.

There's no question the MBA catapulted most of the class into the upper reaches of American society.



MOST-ADMIRED BUSINESS LEADERS

1. Warren Buffett
2. Herb Kelleher
3. Michael Dell and Bill Gates (tie)
4. Jack Welch
5. Oprah Winfrey



Today, the members of the Class of 1992 earn an average salary of more than \$155,200—up from the average \$56,600 they earned in their first post-MBA job. Add in the \$232,400 in average bonus and other compensation—buoyed partially by windfalls earned by alums working in banking and finance—and compensation for the class last year was \$387,600 on average. Compare that to today's average salary for a person with only a college de-

gree—about \$43,400—and the MBA premium comes into focus. It's not surprising that women earn less, on average, or that some are out of the workforce entirely—if only temporarily—to tend to family (table). It's true that the MBA premium for women falls short of that for men, but most women say the degree was worth it.

The Class of '92 may have been amply rewarded, but the group has spread the wealth, too. About 75% of respondents say they gave to charity, with contributions totaling an impressive \$8.25 million in the past two years, or more than \$7,300 each, on average. Nearly a dozen alums gave \$100,000 to charity, with a handful of gifts over \$500,000. Still others donate their time—some 7,000 total hours last year, or about

CLASS OF 1992: PORTRAIT

MEN		WOMEN	
PERSONAL		WORK LIFE	
AGE		JOB OFFERS AT GRADUATION	
38.6 38.1		2.3 2.1	
MARRIED		POST-MBA EMPLOYMENT	
77.3% 67.4%		2.8 2.9	
SINGLE*		POST-MBA PROMOTIONS	
2.9% 14.1%		4.2 4.1	
NUMBER OF CHILDREN		EMPLOYEES SUPERVISED	
2.6 2.2		89 111	
YEARLY SALARY		HOURS WORKED PER YEAR	
\$168K \$117K		53.5 46.5	
OTHER COMPENSATION LAST YEAR		YEARS AT CURRENT COMPANY	
\$273K \$84K		5.4 4.9	
FIRST POST-MBA SALARY		VOLUNTARY BREAKS FROM WORK	
\$58K \$53K		1.4 2.1	

*Single does not include those who said they were in long-term relationships, divorced, or widowed.

hours per month, among the 56% who volunteer. A few, like Gerald Chertavian, do both. The 38-year-old Harvard Business School grad 13 years ago wrote in an application essay about his desire to start a school to train inner-city young adults for the work world. In 2000, he did just that, founding non-profit YearUp in Boston with \$500,000 of his earnings from the sale of a software company he co-founded. He didn't just write a check, though—Chertavian signed up to run the school for 10 years. "If you had good fortune at a time when the market was going sky-high, you have some responsibility along with that," he says. Of course, it's impossible to know what the members of the class of 1992 might have become without their graduate degrees. But the majority of respondents believe that while they probably would have found some success without the MBA, they would not be where they are today. When James M. Berger enrolled in the University of Virginia's Darden Graduate School of Business Administration, he was leaving a career in computer sales, hoping an MBA would open doors to a rewarding, big-bucks career in product management or marketing. Unemployment then was rising steadily, so riding out the bad times in B-school seemed like a good bet.

GROWING SATISFACTION

How alums rated their post-MBA job choices:

FIRST JOB		CURRENT JOB
44.4%	GREAT	58.3%
29.9	GOOD	28.5
12.6	O.K.	6.8
7.2	PROBLEMATIC	2.8

that back in 1992 he didn't know he even wanted. "I value [the degree] even more now that I have more perspective," he says. "Those two years of rigor don't just wash away."

That's not to say the Class of 1992 walked off with all of the advertised benefits of B-school. Alumni networks are often marketed as B-schools' great secret weapon, but even some of the most revered schools haven't delivered on the promise. And looking back, many alums saw their training as too grandiose—overly focused on being a CEO, rather than on the more likely middle-manager role—and not practical enough to prepare them for tackling everyday problems. Some areas, like international business and entrepreneurship, were just "average," many noted.

Still, for many in the Class of 1992, the MBA experience was a life-altering two years. That's as it should be, says Stanford University Graduate School of Business Dean Robert L. Joss. "We want them to be different people when they leave. We want to cause them to think differently, not just learn a particular piece of knowledge," says Joss, dean since 1999. "If it works, students leave and build a career that maybe they never thought possible." And even as the sluggish economy at the time offered little opportunity, the group showed drive. Many say the MBA allowed them to move freely from one industry to another. Indeed, the average 1992 alum has had three different post-MBA employers, along with four promotions since graduation. About 25% have switched fields since their first post-MBA job. Though 2.5% were unemployed at the time of the survey, fewer than 15% of respondents have spent time unemployed since graduation—this despite recent rounds of white-collar downsizing.

Most '92 grads agree on at least one thing: Their MBAs gave them new levels of self-confidence. "B-school removes the blind spots about business at a high level," says Richard Wong, a Massachusetts Institute of Technology's Sloan School of Management grad who is now senior vice-president for marketing at Openwave Systems Inc. Many of the respondents, like Wong, saw B-school as a place where they were immersed in the business world and felt like they were suddenly "in the know."

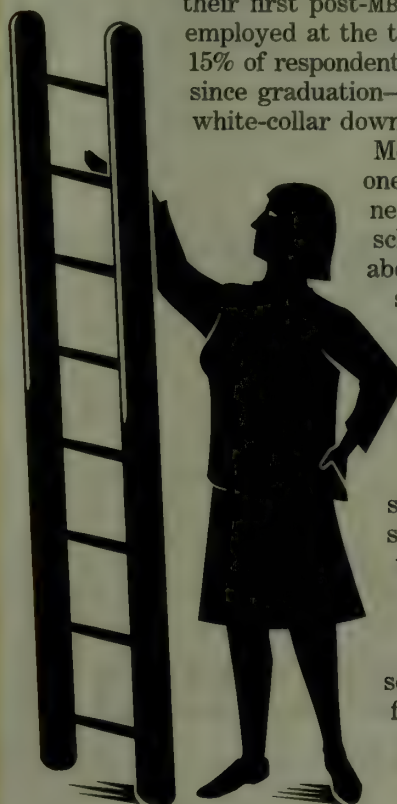
Particularly at top-flight schools like Harvard and Stanford, alums gave more credit to their school's brand name than they gave to any body of knowledge gained in class. Of

MBA A DECADE LATER

Averages of 1,100 men and 396 women respondents

INDUSTRY	EMPLOYMENT
CONSULTING	FULL-TIME EMPLOYED
3% 12.7%	83.7% 62.5%
BANKING	PART-TIME EMPLOYED
3% 17.3%	0.06% 8.4%
TECHNOLOGY	SELF-EMPLOYED
7% 13.8%	3.8% 12.8%
CONSUMER GOODS	INVOLUNTARILY UNEMPLOYED
9% 10.7%	2.7% 1.6%
VENTURE CAPITAL	OUT OF WORK VOLUNTARILY
4% 1.4%	1.8% 13.3%
MANUFACTURING	BUSINESSES STARTED POST-MBA
1% 6.6%	2 1.6
OTHER INDUSTRIES**	BOSSES WHO HAVE AN MBA
2% 37.5%	46.9% 46.7%

*biotech, education, media, and pharmaceuticals
 **Numbers don't total 100%. Nonrespondents and those on leave or retired make up the balance



course, that points to Pfeffer's criticism that the schools are often little more than credential mills. As things stand now, "you get further toward the top of the queue" if you go to certain schools, says Pfeffer. Admits Boston Consulting Group Inc.'s Kermit King, head of MBA recruiting: "Frankly, it's a useful placement service for us."

Moreover, alums across the board said they had counted on fabled alumni networks but had been largely disappointed.

Cover Story

schools low marks—a mere 5 (out of 10) overall. Even schools like Harvard and Stanford, tight-knit Dartmouth and Kellogg, and techno-giant MIT scored only slightly above the average. And alums at Washington University in St. Louis, University of Texas, Indiana University, and Emory University gave their alma maters a 4 or lower. Says a University of

Rochester's Simon School of Business alum: "It's even difficult to find information on other alums." Top B-schools are aware that their alumni networks are undernourished. In the past two years, some, including Harvard, Kellogg, and University of Pennsylvania's Wharton School have launched initiatives to strengthen alumni connections—with the school and with each other.

But if alums haven't always been there for each other professionally, that wasn't the case while school was in session. "The topics of a class I might forget, but not the discussions, not the way people challenged me to think in ways I hadn't before," recalls Darden grad Berger. And

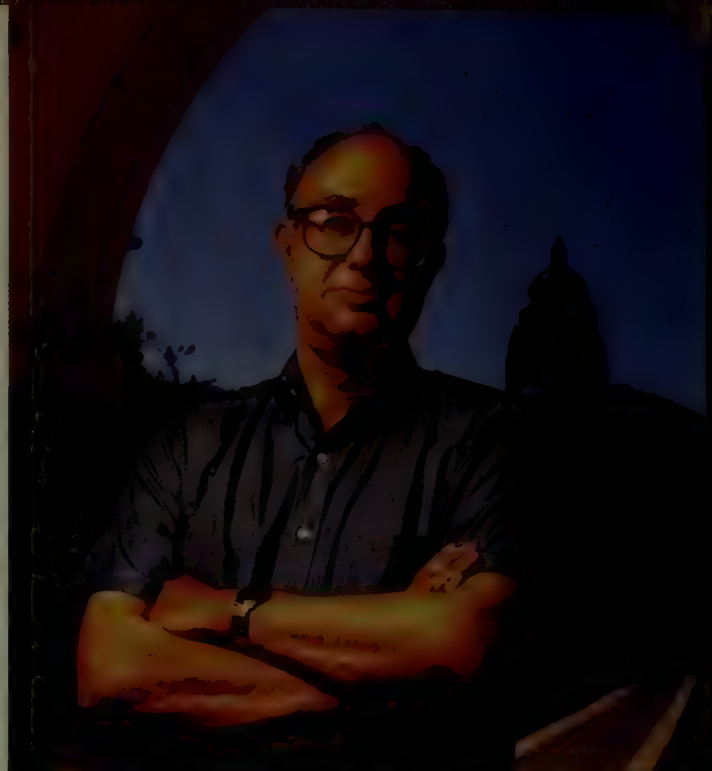
some alums formed lasting personal friendships. Kevin Sidders (Kellogg '92), now a partner at banker Thomas Weisel Partners LLC, says he's in weekly contact with a handful of classmates-turned-friends, sees another dozen about once a year, and attends quarterly cocktail parties.

It wasn't always that way. B-schools were long dominated by a mostly white, male, and hypercompetitive culture—



FAST FOOD

Alums spend an average of **\$115.50** per week eating out socially



SHAKING UP B-SCHOOLS

Stanford's Pfeffer questioned the MBA's value in a 2002 paper

most students hailed from finance and engineering backgrounds. Disdain for the sharp-elbowed types led many employers in the 1980s to complain loudly about MBAs who didn't know how to cooperate. By the early 1990s, top B-schools had responded by diversifying student bodies, drawing from more far-flung fields like marketing, consumer-product management, and manufacturing, and encouraging women and minorities to apply. The new cadre of students and the push to more team-oriented programs led to a transformation in B-schools that was nearly complete by the time the Class of 1992 arrived on campus.

Even as they were learning about teamwork, they also would have benefited from more extensive preparation in entrepreneurship, international business, and information technology, say alums. Granted, in 1992 the Internet was still in its infancy, globalization was not the buzzword it is to

HOW WE CONDUCTED THE SURVEY

This spring, *BusinessWeek* surveyed the Class of 1992 from the Top 30 MBA programs to find out how much alumni valued their degrees. We reached about 4,800 alums (out of a total grad pool of approximately 5,700), and 1,496 responded, or 31%.

To contact the class, we asked schools to provide e-mail addresses for an online survey or mailing information for a paper version to be sent to 1992 graduates by *BusinessWeek*. Several

schools, citing privacy concerns, instead forwarded the survey on the magazine's behalf. About three-quarters of the surveys were completed on the Internet. They were administered by Cambria Consulting Inc., and the results were tested for statistical soundness.

Several institutions—Harvard Business School, University of Pennsylvania's Wharton School, MIT's Sloan School of Business, Yale School of Management, and University of Southern California's Mar-

shall School of Business—did not want their alums to be surveyed and therefore declined to assist *BusinessWeek* in reaching the 1992 class. In those instances, *BusinessWeek* compiled a list of 1992 graduates via publicly available information. We were able to reach more than half of the '92 class at Harvard. For MIT, Wharton, and Yale, we reached about one-third. The response rates averaged about 30%. At USC, we were able to contact less than 25% of the class, and fewer than 30% of those responded, so USC alumni feedback is included only in aggregate data. ■

GLOBAL REACH

368 respondents are not U.S. citizens



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day, and the highest computer processor speed was a mere 25 megahertz. B-schools have long claimed to be thought leaders, with their faculties producing cutting-edge research. But few schools in 1992 anticipated the technological revolution that came a few years later—and alums feel they missed out.

Cover Story

And though they said their preparation to face entrepreneurial issues was merely so-so—and at some schools, poor—that didn't squash their creative spirit. More than 85% of the Class of 1992 helped launch at least one business in the past decade (page 98).

Perhaps the loudest complaint was about just how ill-prepared alums felt when faced with the politics and challenges

SCHOOL TIES

17.9% say they got a job through an alum

75.2% say they have not

TIME OFF

Alums had an average of **26.7** vacation days—and used only **21.2** of them

of managing in the middle. Many say they should have been forced to take more organizational behavior classes, though "it's like trying to get someone to eat their

spinach," concedes 40-year-old Charles W. Breer, a University of Michigan B-school grad who has spent most of his post-MBA career working for Northwest Airlines Corp. Still, actual office politics—the tricky mix of sociology, personality, and corporate culture that exists in every workplace—can make a mockery of B-school theory. Breer says his hardest times were managing a 12-person staff. "At a minimum, wish someone had told me this would be one of the biggest challenges, and then given me some tips," says Breer.

Another issue still facing B-schools today came through loud and clear from the Class of 1992: Women MBAs inhabit something of a world apart—starting with pay. They reported making an average of \$50,000 less in salary than their male

BIG SALARIES—AND SOME REALLY BIG BONUSES

So how did the Class of 1992 do when it came to paychecks? It turns out that of the alums who responded to the bonus question in the *BusinessWeek* survey—1,047 of 1,496 reported their 2002 bonus and other compensation—the answers covered a wide range. By and large, the group is a highly compensated collection of executives in a wide field of professions, from investment banking to construction. Nearly half—48%—received bonuses and other compensation topping \$100,000.

There are also some surprising extremes that skew the averages at several schools. Forty-three alums reported earning \$1 million or more in bonus and other compensation, while 64 tallied between \$500,000 and \$1 million. Of those, many are CEOs or other top officers in sectors such as portfolio management, software, telecom, and consulting, where bonuses can be eye-popping while salaries are more down-to-earth.

In some cases, the average bonuses stand out. At Georgetown, the 46 respondents included several who earned more than \$750,000, mostly in

investment banking, and one who reported an \$11 million bonus. Among Harvard's 107 respondents, six alums earned bonuses of more than \$1 million, including one who raked in \$22

million. Of the 64 Indiana alums who gave bonus information, one landed compensation of \$1.3 million and another received \$10.3 million, thrusting that school, with a number of

alums in international banking, up the list.

Indiana may be something of an exception among Midwestern schools, where many alums gravitate toward less high-flying fields like manufacturing and consumer products. Bonuses among Northwestern alums weren't in the top reaches, for example, reflecting the preponderance of careers in consumer goods, health care, and other related sectors.

Some schools known for catapulting grads into high-paying careers aren't on the list—University of Pennsylvania's Wharton School and MIT, for example. That's because too few responded to salary and bonus questions to make the data reliable.

Of course, there are always a few exceptional grads who outrun the pack and make millions, skewing the norm. Every school has its share, and the Class of 1992 is no exception.

By Jennifer Merritt

RAKING IT IN

The schools whose grads earn the most; average salaries and bonuses

SALARY		BONUS	
SCHOOL*	CURRENT YEARLY SALARY AVERAGE	SCHOOL*	2002 BONUS AND OTHER COMPENSATION** AVERAGE
STANFORD	\$265,160	HARVARD	\$632,045
HARVARD	215,386	GEORGETOWN	575,384
UCLA	196,269	DARTMOUTH	369,050
VIRGINIA	191,106	COLUMBIA	353,317
DARTMOUTH	185,163	INDIANA	308,530
DUKE	170,595	STANFORD	302,024
NORTHWESTERN	168,561	CORNELL	288,350
NYU	158,082	DUKE	247,870
COLUMBIA	156,152	CHICAGO	246,176
CHICAGO	150,509	NYU	217,484
CORNELL	143,363	UCLA	214,200
GEORGETOWN	137,057	NORTHWESTERN	213,679
UNC-CHAPEL HILL	136,561	VIRGINIA	182,462
ROCHESTER	132,781	ROCHESTER	163,267
CARNEGIE MELLON	130,898	UNC-CHAPEL HILL	119,473

*UC-Berkeley, USC, Yale, MIT, Maryland, Purdue, Wharton, and Michigan State were not included because of too few responses to salary and bonus questions. Complete list online

**Includes a few extremely high sums at some schools

Data: *BusinessWeek*, Cambria Consulting Inc.



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counterparts (counting only women who are working). They also switched employers more often and took twice as many breaks from full-time work. A full 13% of female respondents are out of the job market voluntarily; 8% work only part time. By contrast, only 2.4% of the men who answered fall into either category.

Cornell University's S.C. Johnson Graduate School of Management alum Patricia Friar is typical. She left her high-powered, travel-heavy job as vice-president of marketing for a Texas-based company to stay at home with her three young children. After she quit, she first worked part-time, helping to launch DrKoop.com, a health-related Web site founded by the former Surgeon General, C. Everett Koop. But then Friar unplugged—literally. She got rid of her pager and cell phone and did not read e-mail for a

Cover Story

year. Last fall, the 46-year-old went back to work, choosing a lower-paying job with less responsibility. But Friar and many other female MBAs say the degree gives professional women more freedom and marketability to move in and out of the full-time cubicle set.

Most alums—men and women alike—have found their way to the upper echelons of management, but not without some painful comeuppances along the way. Marching into jobs as smug know-it-alls, they soon found out that “you don’t just step into a CEO role after two years of business school,” says MIT alum Wong. “What some people don’t realize [when they graduate] is that being a top manager is an earned right.”

CHANGING PLACES

Alums travel to other countries an average of **1.4** times per year for personal reasons and **3.2** times per year for business



ing MBA culture in Corporate America. These MBAs offer a glimpse of the potentially powerful and productive business talent that spills forth from U.S. B-schools every spring. Those “mills” continue to adapt to the ever-changing economic and challenges of doing business, the value of the degree won’t long be a subject for debate.

With Kate Hazelwood in New York

BusinessWeek online

For more information from the alumni survey, including extensive tables and additional stories on unemployed alums, the philanthropists and international graduates, as well as profiles of several class members, go to www.businessweek.com/bschools/.

And subscribe to *BusinessWeek's* newest feature, MBA Insider, for in-depth guides to several majors, plus admissions-interviews tips, winning application essays, and more, at www.businessweek.com/mbainsider/.

STRIKING OUT ON THEIR OWN

Every morning, Thomas F. Shannon walks to his Park Avenue South office, two short blocks from his brownstone in Manhattan's tony Gramercy Park. Chances are, he will arrive at work on the late side—about 10:30 a.m.—and almost inevitably it's because he was out late at a bowling alley the night before. He wasn't bowling, though. Rather, amid nacho drippings and the clattering of bowling pins, he was surveying his \$30 million empire.

Shannon has come a long way since he graduated from the University of Virginia's Darden School of Graduate Business Administration in 1992 and watched

his fellow graduates march off to high-paying consulting and investment-banking jobs on Wall Street. He took a different path—an unsexy gig at a Pennsylvania can factory. It was the only job he was offered.

But he didn't stay long, instead setting off for the Big Apple, where he struggled for two years before he took a job as CEO of a small health-club chain in 1995. Then, in 1997, with the help of a small-business

loan, his fortunes turned and he became the proud owner of Bowlmor Lanes, an aging bowling alley in Greenwich Village with only \$1 million in revenues. Three bowling alleys and a nightclub later, Bowlmor Lanes, now a Lower Manhattan hot spot, is the flagship property of Shannon's company, Strike Holdings.

When Shannon and his colleagues graduated in 1992, it was still a time when sweat equity

THE ENTREPRENEURIAL URGE

Some 1,300 alums were involved in more than 2,600 startups and gave details about more than 600 of their ventures, from biotech to animal-massage therapy. More than three-quarters of them survived the stock market bust and today employ a total of 98,000 workers.

NEW VENTURES

TECHNOLOGY, SOFTWARE, INTERNET, SECURITY	29%
SERVICE, RETAIL, ENTERTAINMENT, PUBLISHING	21
PORTFOLIO MANAGEMENT, CONSULTING, FINANCE	26
MANUFACTURING, SUPPLY CHAIN, ENERGY	5
OTHER: RESTAURANTS, HEALTH CARE, MEDIA, ETC.	16

ROLE OF ALUMS

OWNER/INVESTOR	11%
KEY IDEA PERSON	35
KEY SALES PERSON	11
KEY TECHNICIAN, OPERATIONS PERSON	15
OTHER, ALL/MORE THAN ONE OF THE ABOVE	27

Data: BusinessWeek Alumni Survey

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and sacrifice were the entrepreneurial expectation. Steady-wins-the-race was the mantra then, before the Internet bubble inflated all those flashy whiz kids. Even so, the '92ers were highly entrepreneurial. Fully 86.6% of the respondents to *BusinessWeek's*

Cover Story

alumni survey have helped to start at least one business—and often more than one.

Their companies range from the kinds expected from MBAs (consulting, money management, and technology) to the less MBA-conventional, like wedding consulting, restaurants, and animal massage. Of the 625 ventures alums detailed, 80% are still in business and employ an average of 215 people, for a total of nearly 98,000 employees. Mitch Roberts, an MIT's Sloan School of Management grad, employs 700-plus workers in his 14 New England-based Panera Bread franchises.

And although the Class of 1992 was post-main-frame but pre-Internet, there is a strong tech dimension. When he couldn't find a job after graduation, Vanderbilt University's Owen Graduate School of Management's Aneel M. Pandey, who developed training software for people taking the Microsoft Corp. certification exam. In 2000, he sold the company, Transcender Inc., for \$60 million in cash to Stamford (Conn.)-based Information Holdings Inc. and remains Transcender's CEO.

Typical of small-business owners, alums have many stories about scrambling for financing, like that of the University of Michigan's Jim Solomon, owner of the Fireplace restaurant in Brookline, Mass. After a miserable six-month stint in corporate finance at Citigroup, he embarked on 17 food-service jobs, countless attempts to raise money, even a move back into his mother's house. With the \$100,000 he salted away, a government loan, and the help of his father and a friend from Citi days, the restaurant opened—al-

most 10 years later—in 2001. Today it's booked solid almost nightly, with \$2.25 million in sales in 2002.

Most prevalent in the class are entrepreneurs who did things sensibly, paying down their school debt by working in the corporate world before striking out on their own. Kellogg MBA Lloyd Cheu intended to run his own small architectural firm but was instead lured at graduation time by the perks of an offer from financial-services provider Public Financial Management in Memphis. But after a decade in corporate life, Cheu started up his own custom-kitchen-design company in New York City, dusting off an old busi-



ness plan he had submitted in a class at Kellogg. "I figured if I could structure a \$350 billion bond deal, I could put 29 design elements in a kitchen," he says.

International students have shown a similar entrepreneurial flair, with 74% having started at least one business. Harish Todi, a University of North Carolina's Kenan-Flagler School alum, started a clothing-manufacturing company in his native

Nepal. His biggest customers? Gap and its Old Navy unit. Georgetown University's Antonio Peña started a construction business out of his car and now owns one of Mexico's largest packing-materials makers.

Entrepreneurial successes weren't always attributed to B-school influence. Some alums criticize their schools for training students more to consult than to run a business. "The assumption was always that we would be able to raise all the money we wanted. But how do you run the business if you have significantly less cash than you need? That is real life," says Dartmouth's Tuck School alum Marwan Naja, who heads a

THE FAST LANE

Shannon transformed an aging bowling alley into a Manhattan hot spot

network-security software company.

To be fair, entrepreneurial education has undergone a revolution of sorts since 1992, as schools have hustled to create real-world offerings, and intensive internships. And many alums insist that when it came time to lure venture capital or present their case to financial institutions, the degree gave them credibility and invaluable financial modeling skills. They also garnered more subtle assets from their programs—confidence, leadership ability, and their school's cachet.

Of course, no program can truly prepare an entrepreneur for the school of hard knocks. When he started his business, Virginia grad Shannon had no money, took no vacations,

and didn't even own a car, while many of his classmates had big jobs and big houses. But 10 years later, he's carting home millions from a business that has turned out to be recession-proof, while fellow grads have watched their corporate jobs implode. For the Class of 1992, some of the risky ventures have turned out to be pretty safe after all.

By Kate Hazelwood
in New York

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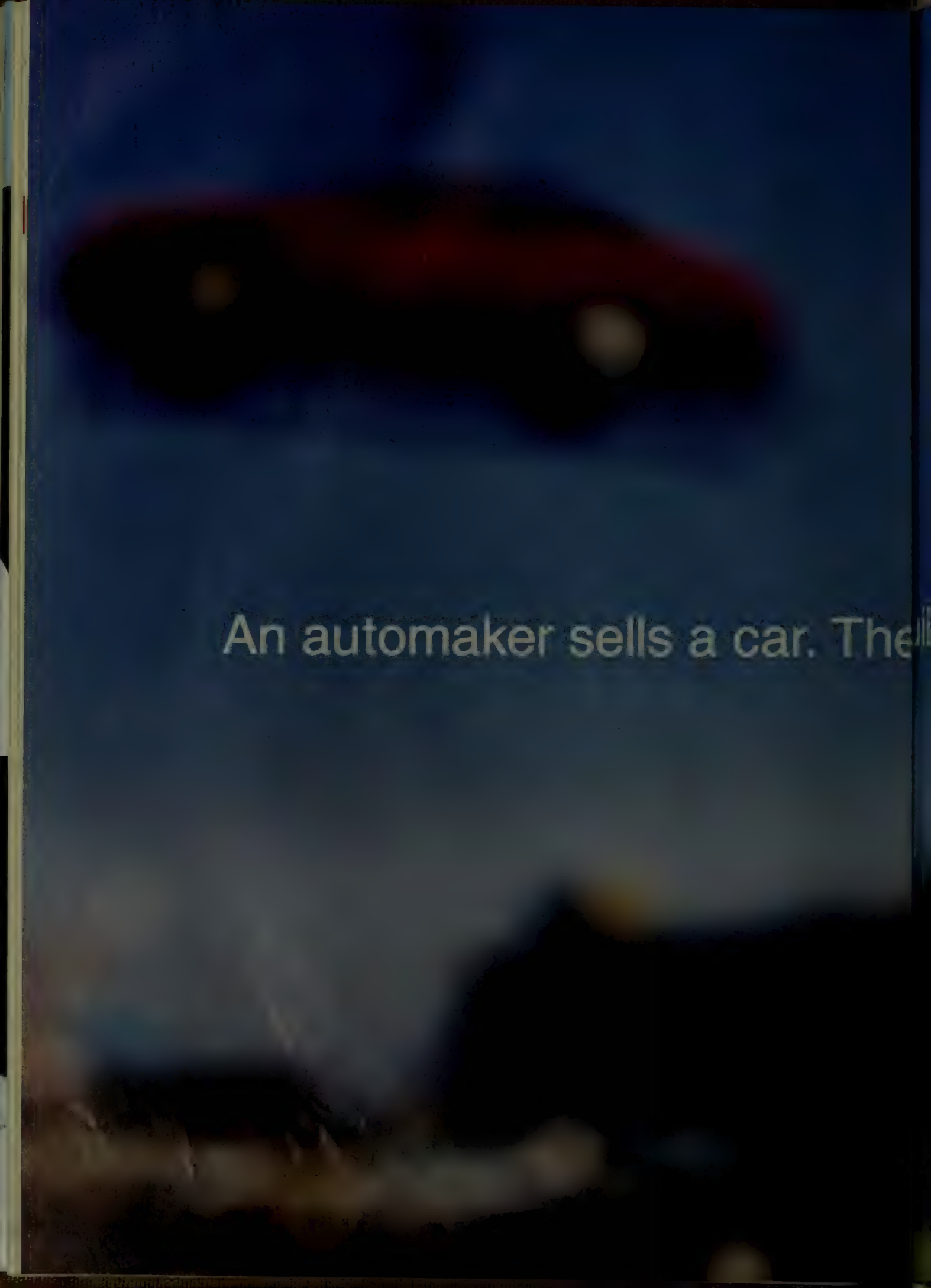
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HOW TO FIX THE MUTUAL FUNDS MESS

Hidden fees, lax boards, and now scandal. Here's what has to be done

Used to be, the worst you could say about a mutual fund was that it lost money. Nowadays, there's worse: losing money dishonestly. Thanks again to the crusading efforts of New York State Attorney General Eliot Spitzer, some mutual-fund managers have made the growing list of investment-industry professionals willing to sacrifice investors' best interests for the sake of profits.

On Sept. 3, Spitzer tore the veneer from the almost pristine, 79-year-old fund business. In a \$40 million settlement with hedge fund Canary Capital Partners, he outlined a series of improper practices in the trading of mutual-fund shares. Not only were four blue-chip companies implicated—Bank of America, Bank One, Janus Capital Group, and Strong Capital Management—but dozens of others, Spitzer suggested, schemed to bilk investors of billions each

CORPORATE GOVERNANCE



Where were the directors? At the fund families implicated in the latest scandal, there apparently wasn't much oversight—and no wonder. A. Max Walker, the 81-year-old chairman of Bank of America's Nations Funds, sits on the board of 85 funds. At another, Janus, the chairman is a director for 113.

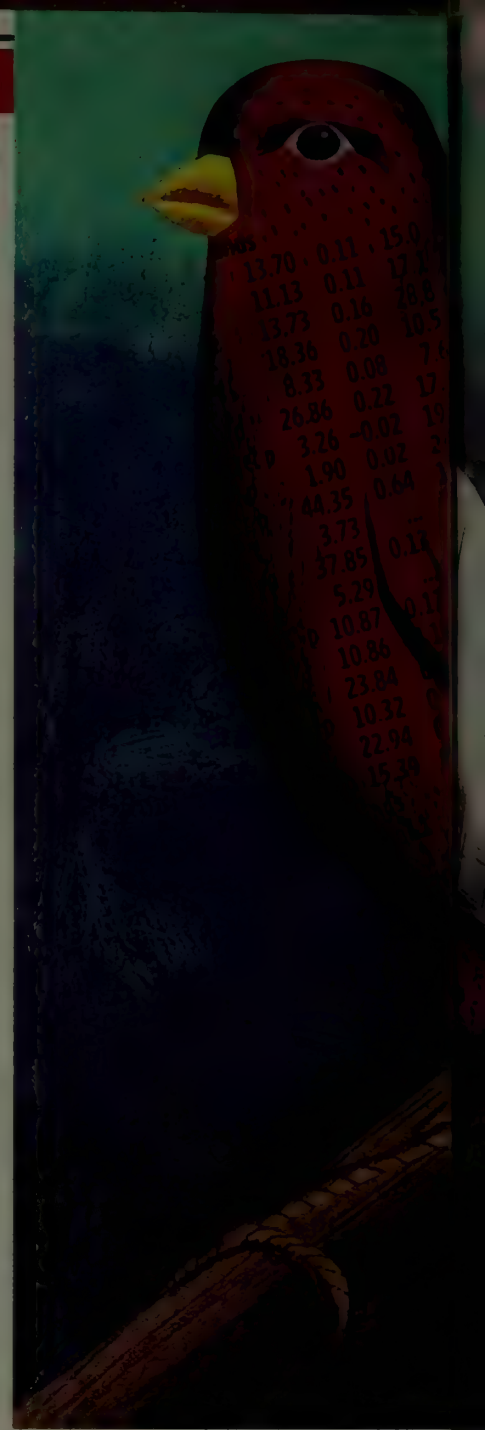
Unusual? Not really. While many governance experts recommend corporate

directors sit on no more than five boards, fund directors typically sit on dozens. By law, each fund must have a board. Most fund families use the same set of directors for every fund in their stable. It's more efficient, they reason, because funds operate similarly. Some 277 of Fidelity Investments' funds, for example, share a common board.

The SEC requires that a majority of those busy directors be independent. But many so-called independent fund directors have ties to the fund managers. The legal definition of "independence" is squishy: The statute lets relatives of fund managers serve as independent directors as long as they aren't members of the immediate family. Former employees of the fund's investment adviser may also serve as inde-

pendent directors just two years after retirement. It's a nice perk: In 2002, the median total pay for directors at the big groups was \$113,000, according to consultants Management Practice Inc.

Little surprise that directors rarely use their authority to challenge the fund adviser. Many routinely approve management contracts at fees that are twice what pension funds pay for stock-picking services. And they are slow to insist that investment advisers cut loose portfolio managers with lousy records. It took the board of Putnam Vista Fund and Putnam's Emerging Growth Fund three years to replace managers in each fund, after they had averaged 24% and 44% a year through 2002, respectively, ranking both at the bottom of their peer group. Fund governance is "fundamentally broken," says



year. "Looks like they are taking advantage of investors like everyone else on Wall Street," says James Punishill, an independent analyst with Cambridge (Mass.)-based Forrester Research Inc.

Spitzer's is just the first salvo. Since then, the U.S. Attorney for the Southern District in New York, James B. Comey Jr., launched his own fund-trading investigation. Representative Richard H. Baker (R-La.), the author of a mutual-fund reform bill watered down after pressure from industry lobbyists earlier this year, is sharpening his pencil. And the Securities & Exchange Commission—already miffed over negligent boards, hidden fees, and conflicts plaguing both the mutual and hedge-fund businesses—plans a rulemaking push in coming weeks. It has now requested details from large broker-dealers, transfer agents, and the 80 largest U.S. mutual-fund families on their trading practices.

At stake is the reputation of an industry entrusted with nearly \$7 trillion of the public's money. More than 95 million ordinary folks rely on funds to finance the American dream: a house, college tuition for the kids, and a comfy retirement.

All of those goals are a little further off, thanks to a vicious bear market. The average stock fund lost 12% a year in 2000, 2001, and 2002, yet funds paid \$62 billion in fees just for stock-picking services alone over the same period,

says consultant Max Rottersman of FundExpenses.com. Worse, funds pay another \$100 billion a year just in transaction costs—according to online trading outfit for fund managers, LiquidNet—partly the result of high commissions, poorly executed buy and sell orders, and unnecessary trading.

Who's watching out for you? Certainly not the fund's board of directors. Most rubber-stamp management's recommendations, and few bother to negotiate lower fees. The largest mutual funds, in fact, pay money-management advisory fees that are more than twice those paid by pension funds.

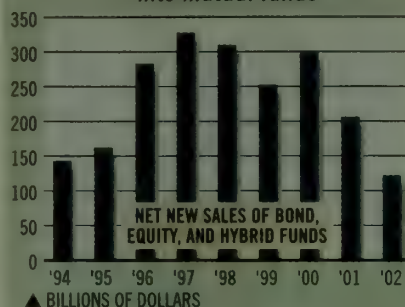
Investors' best hope of reform lies with the SEC. So far, the agency has mostly tinkered with the rules under the widely shared assumption that the industry was largely clean. That may be changing. *BusinessWeek* has learned that the SEC is planning within weeks to push through stricter rules on deceptive ad practices and timeliness of portfolio reports, and to propose new rules on disclosure of fees and revenue-sharing deals with brokers.

Still, that's not likely to be enough. The industry itself needs to overhaul its practices. And shareholders have to be more vigilant themselves. Here is a blueprint for regulators, fund companies, and shareholders to refurbish a business that's too big and too important to fail us.

Still, that's not likely to be enough. The industry itself needs to overhaul its practices. And shareholders have to be more vigilant themselves. Here is a blueprint for regulators, fund companies, and shareholders to refurbish a business that's too big and too important to fail us.

DISILLUSIONED?

Investors are putting much less new money into mutual funds



▲ BILLIONS OF DOLLARS
Data: Investment Company Institute

nsler, co-author of *The Great Mutual Fund Trap*. "Directors too often think the fund company—not the real investors in the funds—as their client."

It's time to shake up fund governance the same way that the 2002 Sarbanes-Oxley Act gave corporate boards a wake-up call. To start, Congress must tighten the definition of independence for fund companies can't use board positions as retirement benefits for their executives. And the SEC should require directors to seek the best investment adviser, based on cost and performance, and to justify the selection to shareholders annually. Directors should closely monitor the performance of their investment adviser year after year.

The fund industry, for its part, must

limit directorships. Many funds in the same category operate similarly, so allowing directors to sit on 10 or even 20 boards may be viable. But directors who oversee 50 or more risk becoming lapdogs instead of watchdogs. Outside directors must take control of meeting agendas. To shake up the clubby culture, they might insist that meetings be held offsite. Boards should require that compliance officers report to them—and adhere to a zero-tolerance policy for violations of fund rules.

Investors must make their voices heard, too. If they think performance is weak or fees too high, they should look at the prospectus for the independent directors and call them to demand an explanation. Directors are well-paid; let them work for that money.

DISCLOSURE



Mutual-fund managers demand all sorts of disclosures from the companies they invest in. Yet funds keep their own shareholders in the

dark about expenses that lower their returns.

Take the cost of trading stocks in a portfolio, one of a fund's biggest expenses. It isn't broken out or included in the expense ratios that funds report. Funds do tell investors how often

they turn over stocks, but the ratio—110%, on average—is buried in the prospectus and may not mean much to shareholders. (It means that a \$100 million fund will make \$110 million worth of trades in a year.) If they saw what that frenetic activity was costing them in dollars, says University of Mississippi law professor and ex-SEC lawyer Mercer E. Bullard, they might demand that funds trade much less. That would benefit investors: Studies show that higher-trading strategies yield lower returns.

Soft-dollar payments aren't disclosed, either. Soft dollars are created when fund managers pay their brokers a higher commission than they have to. Those extra dollars work like frequent-flyer miles, with fund managers using them to get research reports, data feeds, and other aids for picking stocks. But the practice can create conflicts of interest. Managers may churn their accounts to generate more soft dollars in order to buy services such as stock research that investors shouldn't have to pay for.

Fund managers' compensation is also a tightly held secret. But investors need to know what the manager's in-

centives are. Is the pay based on pre-tax returns or aftertax returns, beating an index or just beating the fund peer group, or returns for the quarter or longer term?

Lastly, most funds report their holdings to shareholders only twice a year, not enough for investors to gauge whether they're overexposed to a sector or stock. And too often, their quarterly reports offer broad summaries that don't explain key stock-picking decisions that affect returns. "It's very difficult for even a well-educated investor to have a comprehensive understanding to compare funds," says Baker, chairman of the House capital markets subcommittee.

The SEC has already proposed rules for mutual funds to report their holdings quarterly and give investors more useful data on fees every six months. It's likely to adopt these rules within weeks. It should further insist that funds calculate transaction costs so investors can see whether managers are engaging in rapid-fire trading despite pledges to "buy and hold." In addition, the agency should trim the list of services that funds may buy with soft dollars, and demand they tell

investors what is purchased.

Funds must start telling investors how they compensate portfolio managers—or at least what performance measures they use.

Investors who aren't satisfied with the information they get must speak up. The fund industry is a lobbying juggernaut and will fight hard to squelch most new disclosure requirements. Only by making their views known to the SEC and lawmakers can investors overcome the industry's self-interest.

FEES



One of the fund industry's favorite parlor games is debating detractors who argue that fund fees are too high. The Investment Company Institute, the

mutual-fund trade group, says the majority of stock-fund investors pay on 0.99% of total assets a year in fees. Because that doesn't include such costs as brokerage commissions, one of

A BLUEPRINT FOR REFORM

PROBLEM	CORPORATE GOVERNANCE IS WEAK	FUNDS DON'T GIVE INVESTORS ENOUGH INFORMATION	FEES ARE TOO HIGH	SALES PRACTICES ARE SOMETIMES DECEPTIVE	FUND PRICING IS STILL STUCK IN THE 1940s
SEC SHOULD:	Seek authority to tighten definition of independent director; require boards to justify fees and choice of investment adviser.	Require funds to reveal holdings quarterly, trading costs, and extra commissions paid to brokers, called soft dollars.	Force funds to disclose costs in personalized statements; end marketing fees allowed by law, called 12(b)-1 fees.	Require the NASD to ban broker sales contests and regulate broker and branch-manager compensation. Force funds and brokers to reveal revenue-sharing deals.	Require funds to discourage arbitrage across time zones by updating overseas share prices to reflect market conditions.
FUNDS SHOULD:	Limit number of funds that directors may oversee, and crack down on market-timing abuses.	Disclose portfolio managers' pay and how they measure performance.	Work through Investment Company Institute to develop an investor-education program on how fees affect returns.	Reduce the number of share classes for each fund.	Embrace similar fair value pricing for the benefit of their customers.
SHAREHOLDERS SHOULD:	Demand more accountability from independent directors and look for funds whose boards respond to investor interests.	Counter industry lobbying by writing to SEC and Congress in favor of better disclosure.	Use Web sites and calculator tools to better understand how fees and sales charges are calculated and their impact on returns.	Realize brokers are salespeople first, advisers second. Ask brokers how they are being paid and why they recommend one fund over another?	Shun funds that allow time-zone arbitrage.



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fund's largest expenses, Vanguard Group founder and industry critic John C. Bogle thinks the ICI's number is off by a mile.

Whether fees are up or down, investors should understand this immutable truth: High fees, like weights on a runner's ankles, reduce performance. The difference between a 0.5% and 1.5% fee may seem minuscule, but on a \$10,000 investment returning 5% over 10 years, the lower fee puts \$1,489 more in the investor's pockets. Or look at a recent Lipper Inc. study of money-market mutual funds. The study of 263 funds over the last five years shows that investors could have increased their income by 51% simply by investing in one of the 25 lowest-cost funds.

In the long run, fees can make the difference between investment success and failure. Problem is, it's almost impossible for investors to calculate what a fund's total costs are (table). And the industry, with the SEC's backing, seems to prefer it that way. There are one-time transaction costs, such as sales loads and redemption fees, that don't appear in the expense ratio—the measure of costs that most investors focus on.

And the expense ratio—which includes recurring costs such as management and marketing fees—can be inscrutable because investors never get a bill. Instead, the costs are deducted from the fund's assets and expressed not in dollars but as a percentage of total assets. In other words, what you personally pay is near invisible. That's a boon for the industry, quips ex-SEC lawyer Bullard: "More fee information would make funds more competitive, and that in turn would drive down fees."

That should be the goal. The SEC must require that funds disclose the cost of owning a fund—in dollar terms, not as a percentage of assets—in a personalized quarterly statement. Shareholders should see how much of their money went in and out of a fund, much like a brokerage account.

Some fees should just be eliminated. The SEC should ask Congress for authority to ban marketing charges that funds are foisting on shareholders. Also called 12(b)-1 fees after the 1980 rule that created them, such fees were supposed to be temporary, to help new

THE HIGH COST OF EQUITY FUNDS

Investors pay a range of fees that are charged as a percentage of their investment. Some are disclosed...

■ Average annual management, administrative, and distribution fees, including 12(b)-1 marketing fees **1.44%**

■ One-time sales charge levied by half of actively managed funds **0.2% to 8.7%**

■ Redemption fees, usually charged when fund shares are held less than about three years **0.7% to 6%**

...Many are not disclosed*

■ Portfolio trading costs **0.5% to 1%**

■ Capital-gains taxes due to poor tax planning **1% to 2%**

■ Extra commissions paid to brokers, including "soft dollars" paid in exchange for services **UNKNOWN**

*Annual

Data: BusinessWeek, Morningstar

funds defray distribution costs. Today, they are used to pay brokers and financial planners who sell the bulk of funds. Why should the burden of selling your fund to other investors?

While the SEC agrees that more fee disclosures would help, it's not pushing for individual dollar figures, nor is it asking funds to reveal trading costs. And while it suggested three years ago that 12(b)-1 rule changes were overdue, the SEC has not acted. Just ask any investor: Fees are too confusing. The SEC, with the help of industry, could do a lot to bring about some order.

SALES PRACTICES



With almost as many equity mutual funds as actively traded stocks, the industry has become a marketing machine. Today, most funds have given up selling directly to investors and turned to brokerage firms and financial planners to distribute their products. But such intermediaries now hold all the aces and are extracting ever-higher fees—which investors pay.

What's worse, this new landscape littered with sales practices that are sloppy at best and deceptive at worst. In July, the SEC settled a case against Prudential Securities Inc. alleging that head office managers improperly supervised brokers' mutual-fund sales. Prudential did not admit or deny guilt. A few months earlier, a study by regulators of 43 brokerage firms concluded that fund customers were routinely being cheated out of volume discounts. And studies show that brokers are boosting their pay by herding investors into funds' so-called B-shares, those that levy marketing fees for up to six years instead of a one-time sales charge.

Revenue-sharing is probably the biggest worry. This involves fund companies paying brokerage firms—\$1.5 million a year by some estimates—to guarantee they're on a select list of funds. Brokers almost never reveal to clients that they are being paid more to place clients in certain funds. And while funds reveal in prospectuses if they have such arrangements, they don't say who gets paid or how much.

In August, the NASD said it would propose rules to clamp down on sales space fees, but it didn't go far enough. The NASD would require brokers to tell clients about revenue-sharing deals but not the amounts being paid to the firm or individual broker. This is crucial information to customers, who deserve to know that their broker earned that sales charge and didn't just choose a fund, Chinese-menu-style, off a list.

The NASD also must work harder to close numerous loopholes in existing brokerage rules. It can start by banning all broker sales contests and quotas—inducements that can result in brokers pushing inappropriate funds to unsuspecting investors. Regulators should also ban granting higher commissions to brokers selling the firm's own funds, which often have lower turns. And the NASD must regulate branch managers' compensation. Because many branch honchos are paid a bonus based on how many select-list funds their offices sell, they can place undue pressure on brokers to bend the rules.

Another common selling practice: Funds increasingly offer multiple classes of shares, each with different up-front or backend sales charges. The array of classes is baffling to most investors. The PIMCO Total Return Fund, for instance, has seven share classes. The fund industry, on its own, could end the confusion. Not only are there too many classes, but for some classes there are no common definitions. Thus, what may be the best

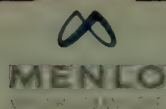


WHO WOULD HAVE THOUGHT
THAT 500 YEARS LATER,
MOVING GOODS AROUND THE GLOBE
WOULD STILL BE JUST AS SCARY?

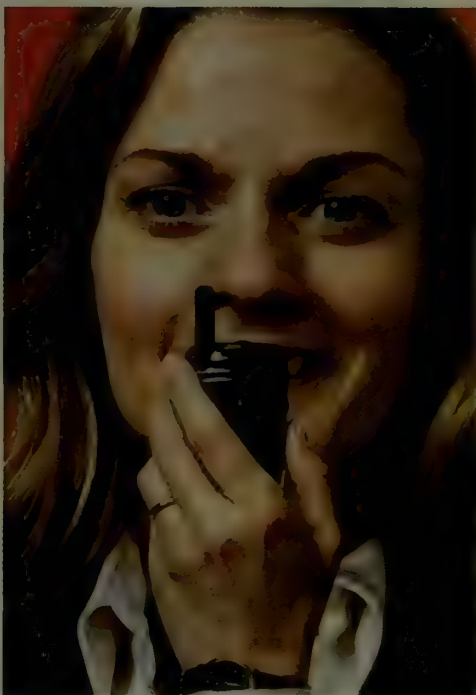
Sure, the monsters have changed, but the fear is the same: something is lurking out there waiting to swallow up your supply chain. What do you do? Find a partner who knows the waters, with the vision to anticipate problems before they arise. A partner like Menlo Worldwide. We're constantly finding more efficient ways to transport supplies,

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class for the investor at one company may be the worst at another.

The industry also can do more to restore its image as a steward of other people's money. Fund companies should act sooner to deny entrance to new investors once a fund reaches a critical size. More funds should take their cues from Wasatch Advisors, a small-cap fund manager in Salt Lake City that just turned off the spigot to six funds; one was closed to additional investors after it took in \$65 million on its opening day. While that limits Wasatch's management fees, it shows the company is putting investors first. Small-cap funds must keep total assets fairly low to be effective. There are only so many good investment opportunities in that sector, and buying indiscriminately merely to put tons of money to work is likely to lead to mediocre returns—or worse.

With most fund groups hungry for money, Wasatch is turning it away. That's the kind of competitive advantage all funds should strive for.

PRICING



The law that governs mutual funds was adopted in 1940, and in one respect the industry thinks it's stuck back in the '40s. Fund companies

price their shares no more than once a day. And with rare exceptions, they sell and redeem shares at prices set at 4 p.m. New York time.

This sets up a huge opportunity for sharp traders in U.S. funds full of European or Asian stocks that stop trading in their home markets hours earlier. Buying these funds at low prices ahead of overseas gains almost assured by rallies in the U.S., traders divert \$4 billion a year from other fund customers, estimates Stanford University.

COMMENTARY

By Gary Weiss

FOUR WAYS TO LIMIT THE DAMAGE HEDGE FUNDS CAN DO

Here we go again—another hedge-fund scandal. These investment vehicles for the wealthy engage in cutting-edge, highly leveraged trading strategies to generate superior returns. But their trading can be, well, a bit too aggressive—so much so that it puts them into periodic conflict with regulators. That is, when the hedge funds are caught. Fund managers say the kind of trading employed by Canary Capital Partners LLC, which may have profited at the expense of mutual-fund investors, has been used by various hedge funds for years.

So what can be done to rein in hedge funds? Quite a lot—if the Securities & Exchange Commission, which has been investigating the industry, has the will to do so. Some fund managers themselves recognize that the \$700 billion industry is crying out for some selective policing to eliminate the bad apples. "What's needed is sparing and smart regulation," says Harry Strunk, a longtime fund consultant who runs Aspen Grove Capital Management LLC, a hedge fund that invests in other hedge funds.

Here are some steps to address ills of hedge funds, both for their customers and the market.

REGISTRATION At a minimum, hedge fund managers should register as investment advisers, an idea being pushed by the SEC. Registered managers are required to open their books to regulators for periodic, sometimes unannounced inspections. Such spot checks may turn up red flags, such as evidence of rapid-fire trading of the kind employed by Canary, an SEC official observed. The fund wasn't registered with any state, but industry estimates show that some 70% of hedge fund managers are already registered with local or state regulators.

DISCLOSURE Hedge funds should confidentially disclose their trading strategies, and use of borrowed money to regulators and their investors. Investors now get little information from fund managers—something that would be disastrous at Long-Term Capital Management, whose highly leveraged trading strategies almost blew apart the financial system in 1998. Re-

business professor Eric Zitzewitz. Fund companies and the SEC did little until this until scholars began calculating the damage in the late 1990s. Now, only half of international funds have taken serious steps to stop. The most common response is to penalize traders who sell within weeks of buying. But that's hard to enforce because orders are often bunched together by brokers. It also hurts customers who must sell for legitimate reasons. Worse, the penalties can be waived, as Attorney General Spitzer noted, for failed customers.

One answer: Follow the lead of the Invesco Atkinson Funds, which stops buying orders on Asia funds when U.S. markets open at 9:30 a.m. But the best solution is for the SEC to press the funds to, in essence, what the traders do: update the fund's price according to what U.S. markets do after overseas changes close. This "fair-value pricing" can virtually eliminate the chances of exploitative trading. Zitzewitz, who started moonlighting for a pricing service after his research drew attention, says about two dozen fund companies—

representing one-third of assets in international funds and including Vanguard, Fidelity, and T. Rowe Price—already use fair-value updates.

Mutual-fund companies have had three years of watching their stock portfolios plunge, and fees along with them. That has tempted some to get creative about enhancing their profits, which has gotten them into hot water with regulators. "Salesmanship and not enough stewardship" rule the day, quips Vanguard's Bogle. While no credibility crisis is well-timed, this one strikes just as investors are returning to the fold, encouraged by the market rally. After yanking a record \$27 billion out of equity funds in 2002—the biggest pullback in 15 years—investors are now channeling in more than they have in almost four years. The speedy restoration of integrity will ensure buy-and-hold investors will keep doing just that.

By Mara Der Hovanesian and David Henry in New York, and Amy Borrus and Paula Dwyer in Washington, with Anne Tergesen in New York



potentially risky vehicles.

TRADING CURBS After the LTCM fiasco, a move to restrict or at least quantify the use of borrowed funds quickly fizzled. The SEC should take a fresh look at curbs on leverage and also specifically outlaw the kinds of trading that unfairly disadvantage other investors, such as the mutual funds in the Canary case.

All this would go well beyond the steps currently contemplated by the SEC. But one kind of regulation that should be avoided is any effort to coddle investors who can afford to play the hedge-fund game. Sure,

Richard H. Baker (R-La.), chairman of the House capital markets subcommittee, recently endorsed more discipline. He should push for it.

REQUIREMENTS SEC Chairman H. Donaldson has correctly decried widespread mass-marketing of funds. Just 10 years ago, says a manager, they were almost exclusively marketed to multimillionaires. And if they were ripped off, who would that be? But now, many funds barely meet the regulatory minimum—earnings of least \$200,000 and a net worth of \$1 million. The SEC should ratchet up those numbers, as it did back in 1982, to ensure that investors have the financial wherewithal to put their money into such

fund prospectuses are a minefield of excessive fees and onerous provisions such as multiyear "lock-ups" in which investors can't get their money. Some fund practices that hurt both investors and the market should be curbed. One example: managers paying themselves performance fees based on their quarterly and not yearly performance. That encourages aggressive short-term trading that can be destabilizing.

The hedge-fund industry is right that their investors are generally sophisticated and able to look out for themselves. The SEC doesn't need to wield a hatchet—but it should look out for the rest of us.

With Amy Borrus in Washington



motorola V60p



'TIS THE SEASON FOR A CORRECTION

The Street is sensing that this rally is due for a dip



It's noon and the Charles Schwab branch at Rockefeller Center in Manhattan is bustling. At least five people are filling out account applications while 10 others, watching the electronic ticker, wait to meet with account reps. "A lot more folks have been coming in," says branch manager Keith Huber. "They want to participate in the rally."

No wonder. Despite a couple of recent down days, the market has been on a tear. The NASDAQ Composite Index reached an 18-month high on Sept. 8. The Dow Jones industrial average is now in its seventh straight winning month and the Standard & Poor's 500-stock index continues its ascent, posting a 15% gain so far this year and a 26% gain from its March low.

But this might be as good as it gets, at least for a while. Market signals point to a likely correction by the end of the month—of as much as 15%—before stocks resume their upward swing, perhaps toward the new year. "The recent rally has just been delaying a much-anticipated correction," says Richard McCabe, chief market analyst at Merrill Lynch & Co. He believes that the market is "overbought"—that is, the 10-day moving average of advancing issues are outnumbering declining issues by a ratio of about 1.7 to 1 (1.5 to 1 is getting lofty, he

says). Also, since 1998, rises in the S&P after March of 10% or more have lasted an average of 79 trading days. But this one has lasted 125 days, making it "too long in the tooth," says McCabe.

Of course, there are sound reasons why stocks are climbing. The economy is improving—some economists are even predicting 5% growth in gross domestic product for the second half of this year. Productivity is high—good for corporate profits. And the dollar has recovered much of its losses of the spring.

But investors often overplay good news. The NDR Crowd Sentiment Poll from Ned Davis Research in Venice, Fla., now stands at about 67%—near the high end of its range. That figure in the past has led to pullbacks of 7% to 10%, says Tim Hayes, global equity strategist at the firm. "It's likely that a correction will take place" this month, he says.

Indeed, September and October are historically the market's worst months. Since 1945, the Dow has posted the worst re-

turns in September, down an average of 0.81%, and has eked out a positive performance only 41% of the time since 1900, according to ISI Group, a broker-dealer and research firm. And October has seen some of the worst crashes in history. One reason for the poor showing in September and October may be that corporations and analysts are often too optimistic in setting earnings estimates earlier in the year, and the third quarter nears its end, they often forced to lower those expectations," says Richard J. Nash, chief market strategist at Victory Capital Management.

That could well be the case this year. The third and fourth quarters are expected to produce the strongest profit of the year, up about 15% year-over-year in the third quarter and 21% in the fourth, according to estimates from Thomson First Call. But with such high expectations, some anticipate at least a handful of negative heads-ups as

BRACING

The earnings warnings may start appearing late September

enter the earnings warning season this month.

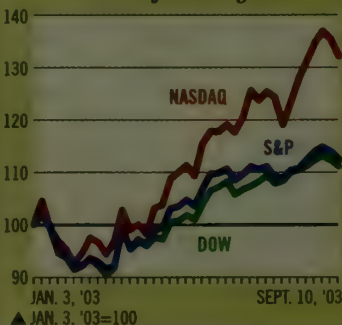
A correction would be healthy for the market, say most servers. "It could be the stage for a

sumption and extension of the underlying major uptrend," says Merrill McCabe. Also, trimming valuations couldn't hurt stocks. The S&P is trading at a price-earnings ratio of nearly 20 based on estimated earnings for the next 12 months, vs. the historical price around 15. But that's still much lower than the p-e of 25 that reigned in 1999. Rising long-term interest rates have helped equity valuations. Bonds, which they offer attractive yields, are a less risky alternative to stocks. Still, Treasury yields remain low. Says Hayes: "The big risk to stocks would be for short-term rates to move up. We don't see that now."

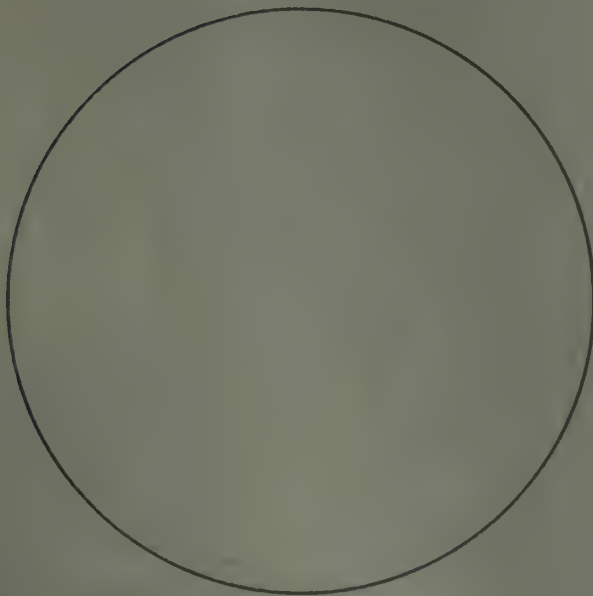
After stocks dip, may be time to buy. That's because on profit warnings are of the way, some strong earnings numbers are sure to follow. Meanwhile, the best advice for the folks in Schwab office and others may be to wait for the correction. The autumn markdown could make for good stock shopping. *By Marcia Vickers in New York*

READY FOR A FALL?

The market has had a spectacular run so far this year



MARKET SHARE 2008



You



Your competition

*The future doesn't play favorites.
It has no winners or losers.
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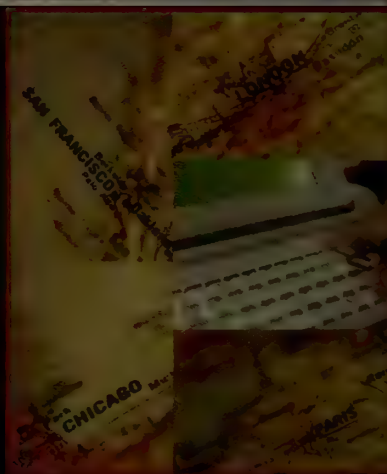
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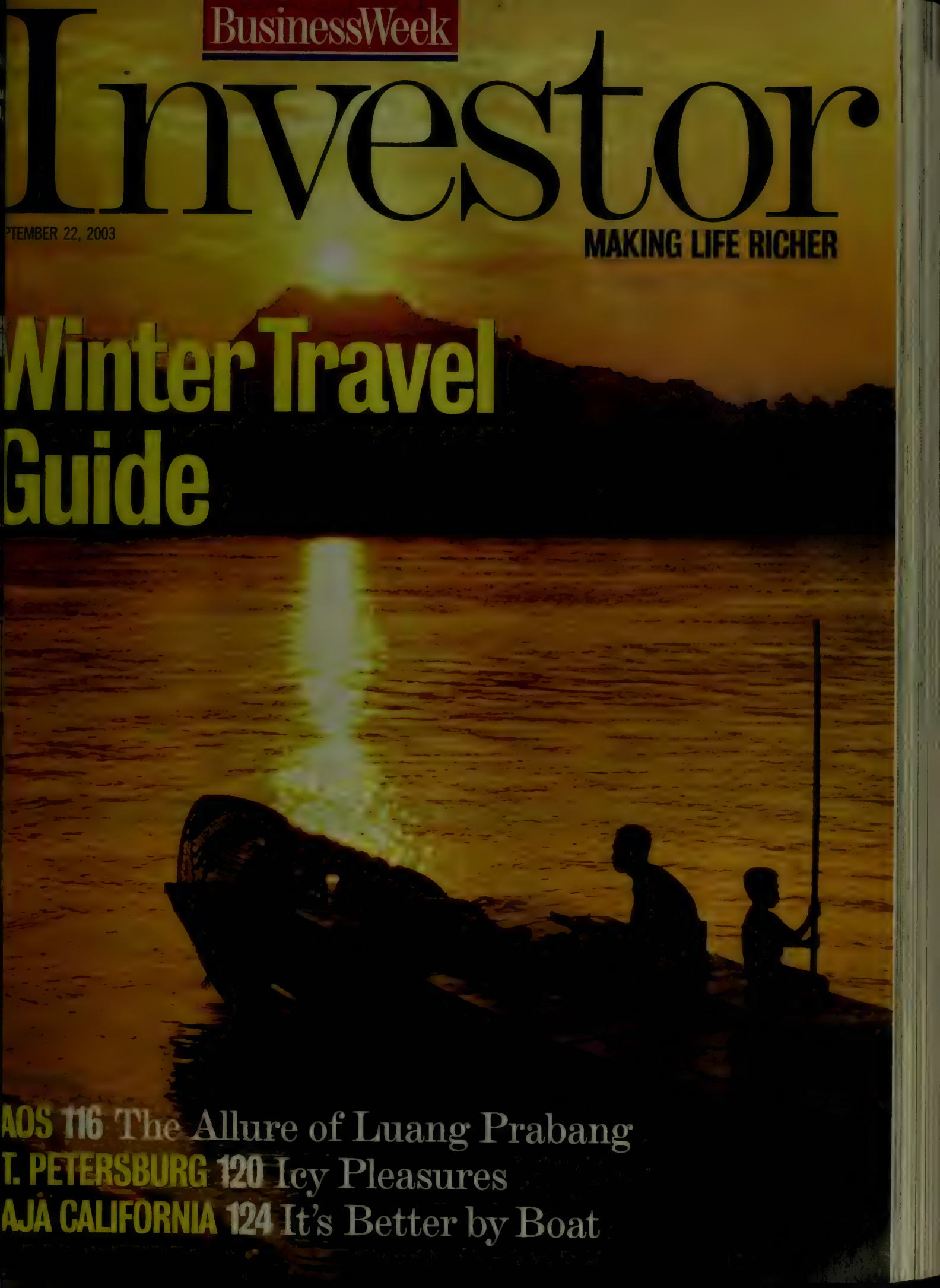
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Winter Travel Guide



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THE STAT

25

LION. The average value of securities-litigation settlements for the first seven months of 2003, up from \$9 million per case in 2002.

Data: PricewaterhouseCoopers

FOOD

IMME FAT

Even the obesity problem, which you would think low-fat foods would be the fastest-growing food group. Instead, ethnic and microwaveable items top the list in the food industry's annual survey.

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PUBLIC SPEAKING

How to Speechify

Bill Clinton and former New York City Mayor Rudolph W. Giuliani make more than \$100,000 a speech, but most businesspeople would happily accept a few sales leads as payment. If you're among them, Amy Kopelan, founder of conference-management company Bedlam Entertainment in New York, has some advice.

Don't snub smaller venues such as colleges, chambers of commerce, places of worship, or local professional organizations. **Good buzz leads to bigger gigs.** Avoid tired topics such as leadership when you pitch to organizers. Instead, identify a new trend, or choose a topical subject such as managing during a company layoff. Tailor your message to your audience, and avoid sleep-inducing PowerPoint presentations.

Kevin Lee, founder of Internet search engine consultancy Did-It.com, offers this: **"Be useful."** He started out by substituting for last-minute no-shows and assembling speakers' panels for free—as long as he could moderate. Now he credits much of Did-It.com's 20% monthly revenue growth over the past three months to his speaking at retail and technology conferences.

Kate Hazelwood



WEALTH

THE RICH WORRY, TOO

Millionaires aren't immune to financial insecurity. A recent Phoenix Wealth Management/Harris Interactive survey of 1,500 individuals with a net worth (excluding debt and primary residence) of \$1 million or more reveals:

- 53% **lost** 25% or more of their portfolio value over the past three years; 24% peg their losses at 40% or greater, while 4% posted gains.
- 31% **feel** they need to save more for retirement to make up for what they lost.
- 40% **donated** less than \$2,500 to charity in 2002, with 10% giving away \$500 or less. Only 5% gave \$25,000 or more.

GIZMOS

POWER UP

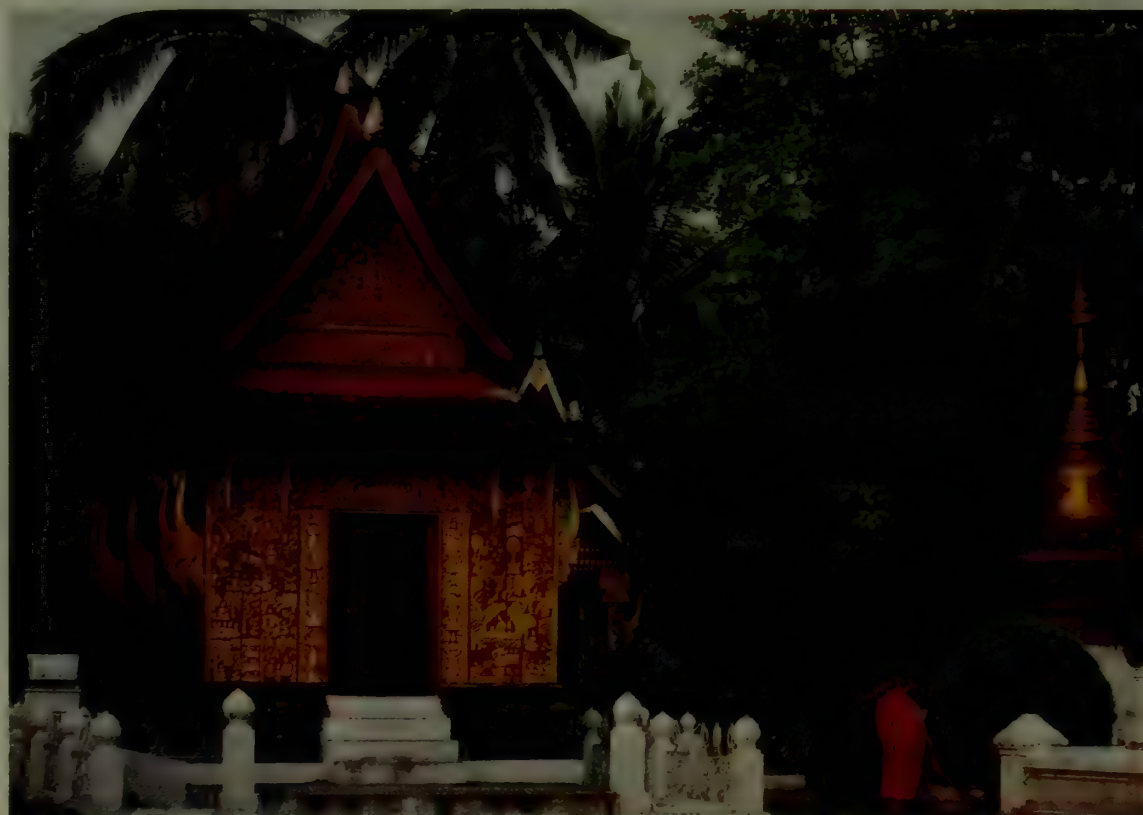
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The Allure of Luang Prabang

This spectacular, unspoiled, river-flooded town, set in northern Laos, turns the clock back to the 19th century. **BY FREDERIK BALFOUR**



Luang Prabang. Even the name sounds languorous, rich, and exotic. Located on a lush peninsula flanked on one side by the swirling waters of the Mekong River and on the other by its tributary, the Nam Kan, this ancient royal capital is surrounded by mountains. Luang Prabang remains one of the

WAT XIENG THONG:

The royal temple, like all attractions of the old city, is easily reached on foot

last truly unspoiled posts of Southeast Asia. Having been opened to individual travel only in the early 1990s and declared a UNESCO World Heritage site in 1995, Luang Prabang's old city (population 15,000) sometimes feels more like it exists in the 19th century than the 21st.

Luckily for American tourists, modern air travel makes this Indochinese treat easily accessible. Direct flights from Bangkok on Bangkok Airways cost just \$180 round trip. Obtaining a tourist visa at the airport takes 10 minutes, \$40, and two photos. (On a recent trip, I arrived without my photos but the immigration official happily waved through anyway.)

The best time to visit

Luang Prabang is in November and December, after the monsoon rains subside. Evenings are cool, and it's misty at dawn, but by midday the sun can be punishingly hot. That's a good time to seek a shady respite at one of the city's more than 40 temples, known as *wats*. Most of them double as places of worship and seats of learning for the 100 boys who join the temples and shave their heads in exchange for a free education.

If you visit only a single *wat* in Luang Prabang and that would be a great shame—don't miss the city's most venerable complex, Wat Xieng Thong. Built in 1560, it was the royal temple until the Communists took over Laos in 1975. Its multilayered, curvilinear roof, gilded doors, and splendid glass mosaics depicting scenes from the Buddha's life are



lush garden filled with coconut palms, me trees, and gainvillaea.

Old Luang Prabang occupies a peninsula two-thirds of a mile long and a few hundred yards wide, and you can easily reach all of the town's attractions on foot. Many architectural treasures from the French colonial period have been converted

into guest houses and hotels. The eponymous Villa Santi Hotel (villasantihotel.com) is run by Santi Inthavong and his wife, Sawee Nahlee, the granddaughter of the last king of Laos. For \$90 (double) you can bask in the atmosphere of royal yesteryear. The main house formerly belonged to the king's concubine. The newly refurbished Pansea Luang Prabang hotel (pansea.com/laos.html) on the city's outskirts goes for a more princely \$150 to \$175. Both can be booked directly on the Internet.

Undisputedly the best-known event in old Luang Prabang is the daily procession, at the crack of dawn, of saffron-robed monks holding their brass begging bowls. More than 300 of them, ranging from age 8 at the front to more than 80 years old at the rear, trudge barefoot in single file past the kneeling denizens of Luang Prabang, who fill the bowls with sticky rice.



But the monks don't survive on rice alone, and you needn't, either. The cuisine of Laos is fresh, spicy, and cheap. A meal of green papaya salad, noodle soup, a steamy local delicacy called *lap* made of minced lamb (or fish or pork), mixed with local herbs and eggplant, sticky rice, and a glass of wine or beer will set you back about \$5 at a riverside restaurant.

No trip to Luang Prabang would be complete without a relaxing cruise up the magnificent Mekong River. You can hire private boats for \$18 a day to ferry you north to Pak Ou Caves, where thousands of Buddha statues repose in a limestone grotto high above the rushing current.

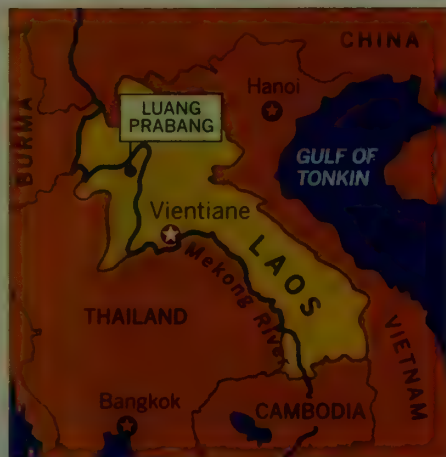
On the way back to Luang Prabang, you can pull in at riverside villages and see handmade mulberry paper drying outside, women weaving at their silk looms, and men making Lao Lao, a fiery rice wine fermented in clay pots in the sun.

ALL IN A DAY'S SIGHTSEEING

At dawn, saffron-robed monks receive rice; you'll dine on fresh local produce

Make your last stop at the village directly opposite Luang Prabang. It offers breathtaking views of the city as the spires of its *wats* catch the last rays of the setting sun. Then, for less than \$3, you can finish off your day with a soothing natural-herb steam sauna and massage at the Lao Red Cross. It may all sound too good to be true, but I have been back every year since discovering Luang Prabang in 1995. So far, this sleepy treasure has lost none of its charm.

■



GETTING THERE

ASIA'S GREAT BARGAINS

If you've ever dreamed of scaling Mount Fuji, kayaking off the beaches of Thailand, or standing in Tiananmen Square, now might be your best chance. Many tour operators, airlines, and hotels are offering bargains in Asia, thanks to the economic downturn at home, the continued fighting in Iraq, and post-SARS anxieties. "It's an excellent time to go," says Karin

Hansen, a Deerfield (Ill.) travel agent who specializes in China. Hansen says she is booking rooms in Beijing's high-end hotels, such as the St. Regis, for \$280 a night, about half the cost of a year ago. Carriers such as **UNITED AIRLINES, NORTHWEST AIRLINES, AND CATHAY PACIFIC AIRWAYS** also are offering special deals this fall. United has partnered with the Hong Kong Tourism Board and declared October "Visit Hong Kong Month." Flying between New York and Hong Kong in mid-October will run about \$648 round trip. Competitor Northwest has one-way fares starting at \$269 be-

tween San Francisco and Tokyo. Buy a business-class ticket on Cathay Pacific to Hong Kong, Bangkok, or Singapore, and bring a companion for \$50 when you use an American Express card.

Got wanderlust? Check out **CATHAY'S ALL ASIA PASS**, which, for \$999, allows you to travel for 21 days to as many as 18 Asian cities. But make haste to reserve. Aviation analyst David Swierenga says that while passenger numbers remain down from last year, "the impact of SARS is beginning to wane," which means those bargain prices could shoot up.

Julia Cosgrove

Sparkling Shanghai

It's old, it's new, and in the wake of SARS, discounts abound. **BY FREDERIK BALFOUR**

FOR A TASTE OF China's rich history as well as a glimpse of its future, there is no place like Shanghai. From the 4,000-year-old bronzes in the Shanghai Museum to the art deco treasures of the 1930s and the futuristic skyline of Pudong, Shanghai is a fascinating juxtaposition of old and new, East and West, stylishness and kitsch.

The best place to start your visit is on the Huangpu River, which separates the western part of Shanghai from Pudong, China's financial center in the east. Walk along the famous Bund, built on the profits of the opium trade after the British forced China to open up Shanghai to foreigners in the mid-1800s. It formed the heart of the foreign community until Shanghai fell to the Communists in 1949. Luckily, city elders preserved these glorious monuments of the colonial-capitalist era, providing the visitor with a delightful one-mile sweep of neoclassical and art deco structures. The free Bund Museum offers a superb collection of historical photographs.

Next, continue north, crossing the Suzhou Creek, to explore the back alleys of old Shanghai. The facades of its narrow houses present a jumble of ironmongery, plants, bird cages, and laundry hung from bamboo poles. Old men in pajamas, sitting on folding chairs in the street, smoke cigarettes and sip chrysanthemum tea. Sadly, such neighborhoods are fast disappearing in Shanghai, where tens of millions of square feet of old buildings fall victim each year to the wrecking ball.

In a city of pell-mell progress, Yuyuan Gardens is a welcome oasis of tranquility. Located in the ancient Chinese quarter of Nanshi (Southern City), the gardens were built during the Ming Dynasty in the 1500s. They're considered one of the finest classical gardens in China, characterized by artificial waterfalls, jade outcroppings, and miniature mountains. A visit to the adjacent Mid-Lake Pavilion Teahouse is also de rigueur.

At the end of a long day of sightseeing, head over to the Grand Hyatt Hotel in Pudong. It occupies the 53rd to 87th

floors of the spectacular 88-story Jinmao tower (the top floor an observatory), China's tallest building. The Cloud 9 bar on 87th floor offers breathtaking views of the Bund. Rooms at 555-room Hyatt start at \$320 plus 15% for a double, though booking online can save money. For a bit less, I prefer the centrally located Portman Ritz-Carlton. Elsewhere, many of post-SARS inducements offered to lure tourists back to the city are still in place, and discounts of up to 40% at the Shangri-La Hotel and the Westin Shanghai will get you a room for \$160 to \$200. Late fall will be a good time to take advantage of introductory offers by the JW Marriott, that's slated to open in late September. If you're willing to forgo broadband connections and 24-hour room service, the Heng Shan Motel or Rui Jin Hotel are both beautifully renovated former mansions, with rooms starting at \$90.



Shanghai may soon rival Hong Kong as a shopper's paradise. Unlike the former British colony, Shanghai has banned vehicles from the heart of its shopping district along Nanjing Road. Dongtai Road antique market is the place to pick up kitschy clocks, posters, and other Mao memorabilia from the Cultural Revolution.

If you still have energy for Shanghai's famous nightlife, check out the Xintiandi district's bars, restaurants, and galleries in restored brick houses, called *shikumen*, unique to Shanghai. The slightly seedier area around Maoming Road is also a favorite nocturnal haunt for expats and Chinese professionals. Best to save these diversions until the end of your visit—that way, you can use the plane ride home to recover.



LOCAL COLOR

The Bund's one-mile-long sweep of neoclassical

July 2004

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Winter Wonder

Snowy weather becomes St. Petersburg—especially as it marks its 300th birthday. **BY DAVID FAIRLAMB**



ICY PLEASURES: Troika racing (left) and the lavishly restored Church of Our Savior on the Spilled Blood

The city, built on 42 islands connected by 340 bridges, is one of the most beautiful in the world. Peter the Great and his descendants spent lavishly to make sure it would rival

WINTERS IN St. Petersburg are bitterly cold. The river and canals freeze over. A frigid wind sometimes blows in from the Gulf of Finland. But don't let that stop you from spending a Christmas or New Year's break in Russia's breathtaking former capital.

The city looks magnificent in the snow, and the icy weather enhances the innate party spirit of its irrepressible inhabitants. The locals say they get depressed only when the temperature falls so low that vodka turns to ice—something that hasn't happened for years in a city where the average daytime temperature in January is 29F.

The mood in the "Venice of the North" this winter will be particularly uplifting. It's 300 years since reformist czar Peter the Great founded his "gateway to the West" at the mouth of the river Neva (pronounced nyeeVAH). And St. Petersburgers—*Pitertsi*, as they are informally called in Russian—are celebrating their special anniversary in style. Buildings have been restored, the local infrastructure improved, and special art and history exhibitions organized. Christmas and New Year's festivities are going to be even more sensational than usual. Two of the hottest—and most expensive—tickets in town will be for the New Year's bashes at the luxury Grand Hotel Europe and the Sheraton Nevsky Palace Hotel. But just about every restaurant in the city will be throwing a party.

The main reasons for going to St. Petersburg are to see its wonderful architecture, visit its magnificent museums, uncover its turbulent past, and—for those lucky enough to score a ticket—take in a performance by the Kirov Ballet.

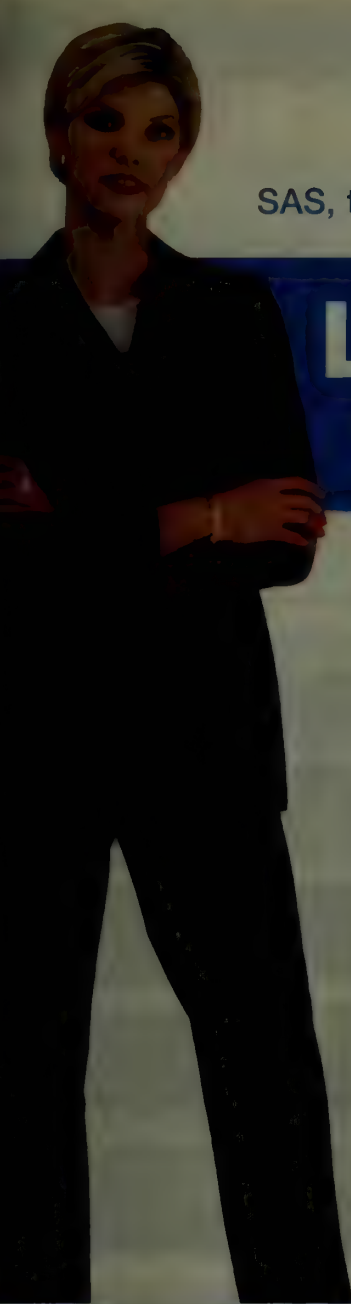
the great cosmopolitan centers of the West.

Famous architects, such as the Italian Bartolomeo Rastrelli (who designed the Winter Palace) and the Frenchman Richard de Montferriand (St. Isaac's Cathedral), were hired to construct landmark buildings. Miraculously, most of them survived 70 years of communism and the devastating 900-day German bombardment during World War II. No high-rises were allowed to be built in the center, so visitors can enjoy unspoiled views of the city's spectacular buildings.

They include the St. Peter & Paul Fortress, which Peter the Great built in 1703 to defend the entrance to the Neva, and the lavishly restored Church of Our Savior on the Spilled Blood. (The blood in question belonged to Czar Alexander II, who was mortally wounded by an assassin on this spot in 1881.) An intricate, multicolored, onion-domed masterpiece in the Russian revival style, the church is generally considered the finest building in St. Petersburg.



The high point of any visit to St. Petersburg, which was Russia's capital from 1713 to 1918, is a tour of the Hermitage, the splendid museum housed in the Winter Palace, the former residence of the czars, and two adjacent buildings. Its 400 glittering, gilded rooms with the marbled floors, coffered ceilings, and crystal chandeliers



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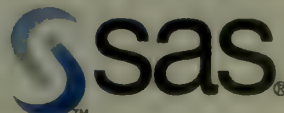
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are dazzling. That's before you start on the art collection, which includes paintings by da Vinci, Raphael, Rembrandt, Manet, Renoir, and Picasso. From Oct. 14 to Jan. 25, 2004, there is a special exhibition of the Stroganoff Collections, which include works by Rembrandt, Botticelli, and Watteau. There's so much worth seeing at the Hermitage, it's advisable to make two or three short visits rather than trying to cram everything into one session.

Even in winter, make sure to venture outside the city. A ride through the forests on a troika—a sleigh pulled by three horses—is a real treat. So is a visit to the opulent Catherine Palace, built in Tsarskoye Selo (also known as Pushkin) as a summer residence for Peter the Great's wife and successor Catherine I. During the war, the Germans looted everything from the palace, including the famous Amber Room with its walls covered in intricately worked amber. The palace has been

renovated and, this summer, the Amber Room reopened at \$60 million of restoration work.

St. Petersburg, which for most of the communist era was called Leningrad, is not the best place to go shopping whenever the season. Antique Russian artworks are available at reasonable prices, but it can be difficult to get a permit to export them. Many other goods are more expensive than they are in Western Europe or the U.S. First-class accommodations can range from \$400 to \$500 a night—especially if you want to stay at a luxury hotel like the Grand Hotel Europe. There are plenty of cheaper alternatives, such as Otkiabrskaya or Vyborgskaya, which cost less than \$100.

Visitors arriving at the airport can find the long lines at passport control irritating. But a trip to the city of the czars makes an excellent winter break. It may be cold, but you'll find the cultural and historical experience invigorating.

Penguins On Parade

Visitors flock to watch this nightly spectacle. **BY JEFFREY M. LADERMAN**

THE SUN HAS nearly slipped into the Bass Strait, the treacherous waters that run between the south coast of Australia and Tasmania. In the last remaining daylight, you can spot a few small white dots darting about the shoreline. They move closer, stop, move back and forward, and soon another cluster comes out of the surf, and another. As the dots get closer, you can make them out for what they are: the snowy chests and bellies of penguins. The Phillip Island Penguin Parade has begun.

Standing only 13 to 16 inches tall, the hundreds of "fairy," or little, penguins that live on the dunes behind the island's Summerfield Beach are the smallest of 17 species. And unlike most species, their feathers—except for the white chest and belly—are dark blue rather than black. They spend the day—or several days, in the nonbreeding season—at sea, foraging for anchovies, pilchard, squid, and small crustaceans. They return to land only under the cover of darkness.

Their nightly parade is one of Australia's most popular wildlife attractions. The Phillip Island Nature Park—a 90-minute drive south from Melbourne—makes the bird-watching easy. You can view the procession year-round from a seaside amphitheater. The beach is bathed in a soft light, roughly that of



a full moon; any brighter and the penguins might not march.

After the first few groups of birds cross the beach and head up the dunes, so do the visitors. Boardwalks cross the dunes, and every one is a great viewing stand. They're raised with enough clearance so the penguins can waddle under them on the way to their burrows. On the night I visited, I found a group of eight idling at the point where the dunes meet the beach. They stood there for at least five minutes, moving around in place, much like a group of marchers might assemble for a parade.

Then the lead penguin started his way up, and the others followed. As they ascend, penguins peel off from the group, each heading to a different burrow. Although there's no music in this parade, there's plenty of noise as the penguins squawk loudly, to warn away rivals and attract mates.

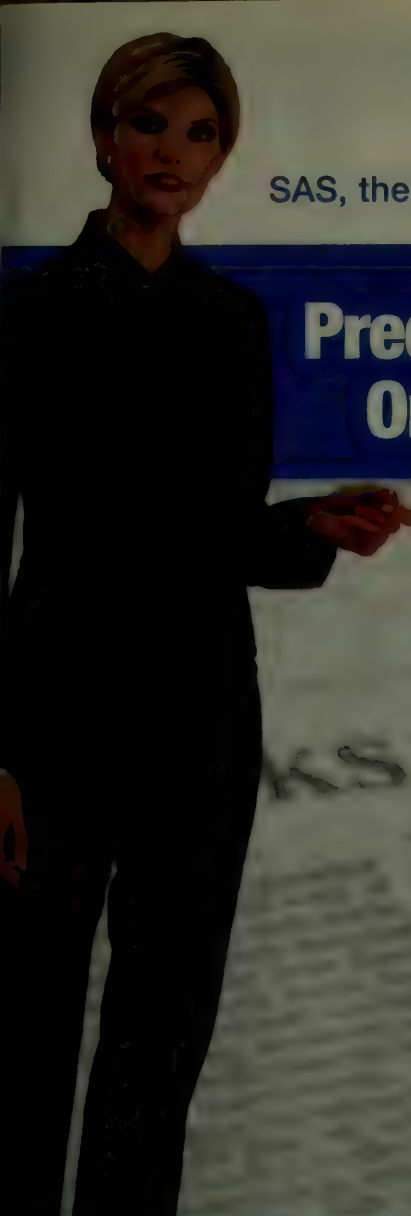
If you're going to attend the parade, plan to arrive at least an hour before sunset—early enough to take in the visitor center exhibits, including the nesting boxes where you may see parents and chicks. Bring warm clothing, even in summer, which runs from December through March. Admission costs about \$10 for adults and \$5 for children. Bus tours from Melbourne run about \$50 to \$70, including admission. If you want photos, you'll have to purchase them, since

photography is prohibited. (For more info, and a parade video, visit www.penguins.org.au.)

On the way out, remember to check around your car before starting it. On their way home, penguins sometimes cut through the parking lot.



READY, SET, WADDLE:
They march after the sun sets



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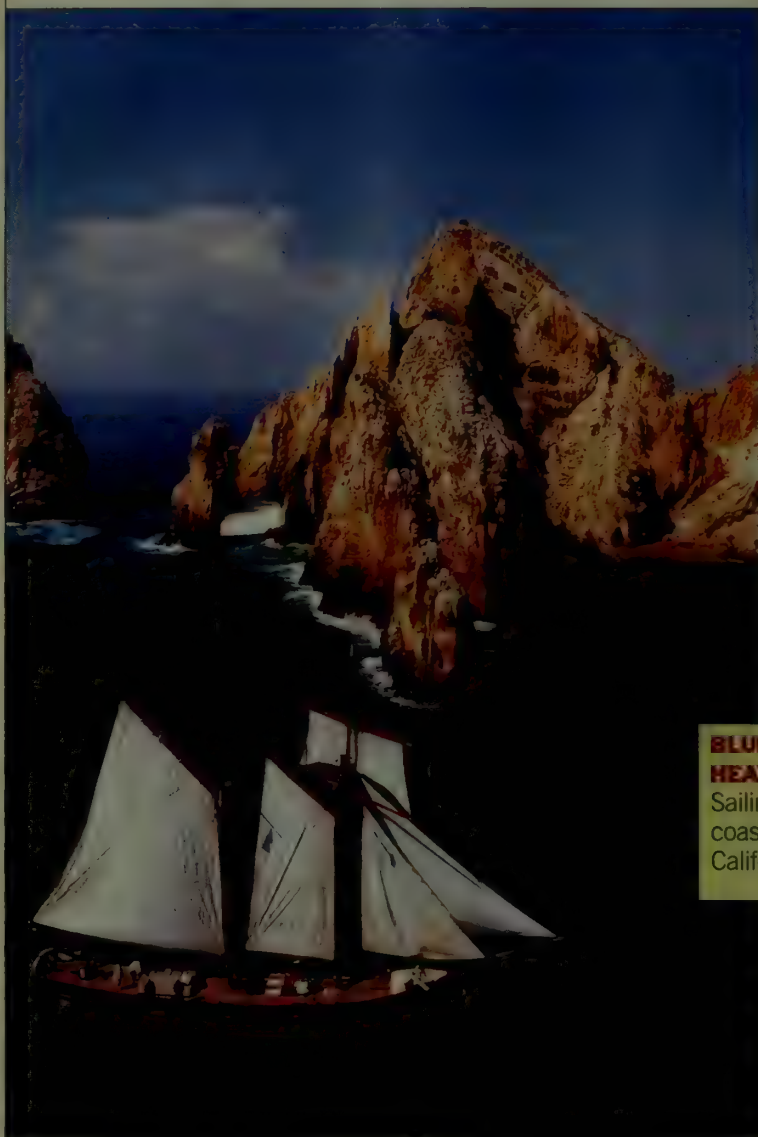
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BLUE

HEAVEN:

Sailing off the coast of Baja California

Baja By Sea

On a crewed sailboat, all you have to do is say "ahh." **BY KATHLEEN KERWIN**

THE SUN IS drifting into the Sea of Cortez as we settle into seats on the deck of the 65-foot sailboat God's Grace, icy margaritas in our sunburned hands. The kayaks we were paddling a few hours ago are safely stowed near the prow, and our snorkeling gear is still dripping on the floor. This just might be the perfect getaway from the barrage of news about war and terrorism back home. My idea of paradise is just a two-hour flight from San Diego and a

2½-hour ride in a van up the coast of Baja California.

Our party of five friends set out from La Paz, Mexico, a few days ago on a cutter chartered from Baja Coast SeaFaris. We're in the care of captain Jim Loberg, a former naval aviator, and his wife, Estrella, a La Paz native who acts as first mate and cook.

On previous land trips, we've found Baja to be friendly, relaxed, and inexpensive. But for sheer ease, nothing beats a fully outfitted five-day cruise. The itinerary is ours to customize, including whether to choose daily paddles that are strenuous or easy enough for beginners. Except for the dinner wine, ordered in advance, the outfitter's \$1,270 per-person charge covers everything—including plenty of water-sports gear for when we're not lazing around.

Our past excursions in the Sea of Cortez were limited by how far we could kayak in a day. The sailboat expands our range to include scenic islands such as Espiritu Santo and Isla Partida, 28 miles offshore. From our anchorages, we can launch two double kayaks and paddle in close to explore the cactus-studded cliffs, secluded beaches, and nesting places of pelicans, herons, and frigate birds. Hiking a steep trail to catch a ridgetop view gives us a chance to stretch our legs.

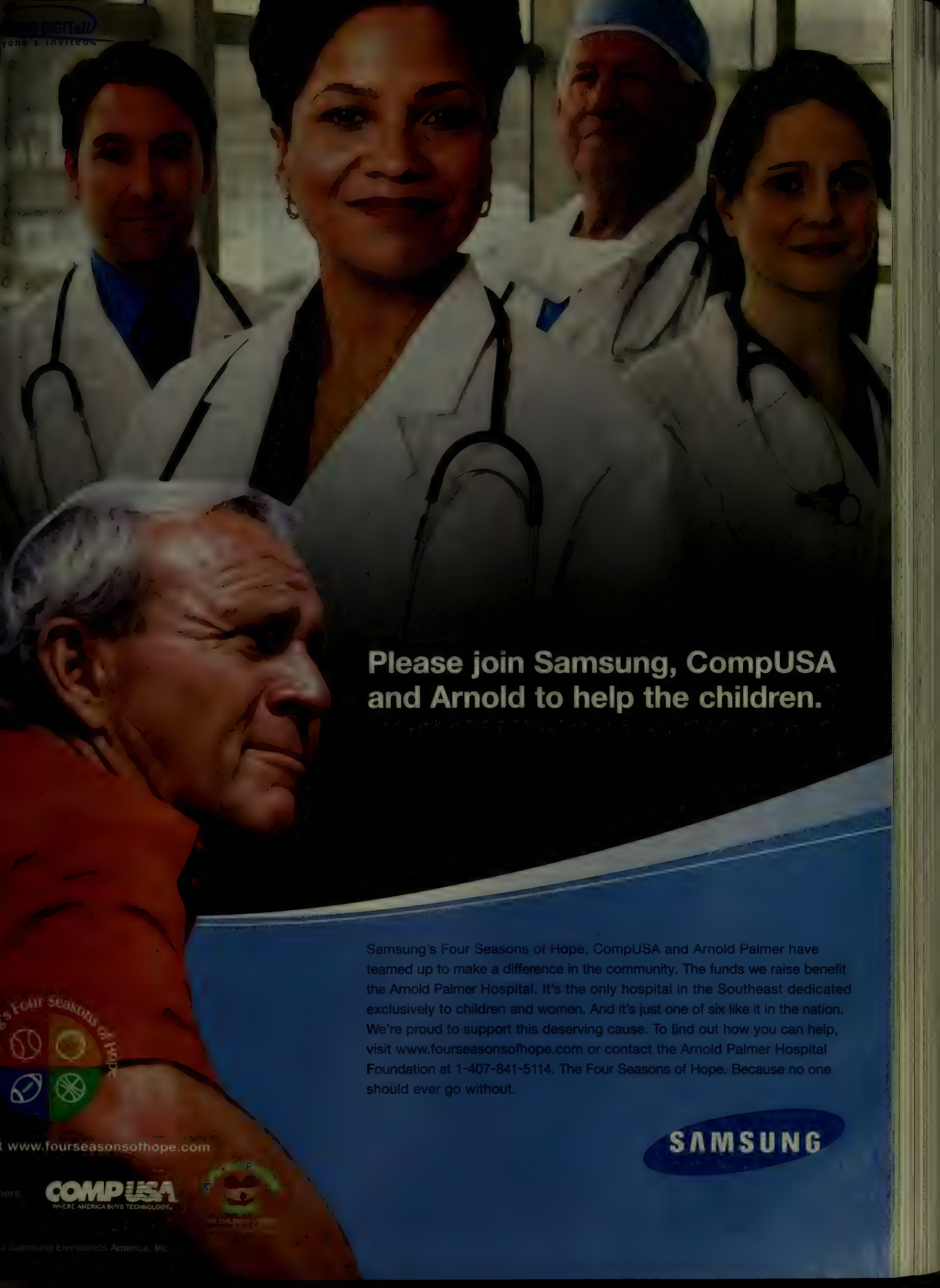
On our second day out, we visit Los Islotes, home to a large sea lion colony. We launch the kayaks and paddle in for a closer view, minding our distance from the massive bulls, their harems, and the curious pups. As we paddle around the back of the rocky isle, you can see the males practice their bellowing skills on us, much like adolescent boys showing off voices that occasionally crack.

On other days, we snorkel around reefs near islands that teem with fish in dazzling colors. One morning a school of dolphins follows us for a half-hour, cavorting alongside the boat. Sunsets are uniformly gorgeous, the star of the show. The clear desert air never gets any clearer. Sleeping berths are cramped, and privacy is limited, but we spend most of our time up top or in the water anyway.

"Anybody want to fish?" captain Jim asks one morning. We've seen a few dorado (a.k.a. mahimahi) skipping over the waves. We toss in a line, and the rod soon bends sharply. I start reeling frantically. A gleaming dorado breaks the surface, then makes a run for it. More frenzied reeling, and Jim leans off the back to net my fish, which he estimates at 25 pounds. The skipper euthanizes it with a splash of vodka in the gills. "Not the tequila," he says. "We need that for margaritas later." In an hour, we're sitting down for lunch: Estrella has sautéed golden chunks of dorado to wrap in warm tortillas with homemade salsa—the best fish tacos of my life.

Baja Coast SeaFaris (from the U.S., call 011 52 612 12597 or send e-mail to info@bajaseafaris.com) offers trips for two to eight people. La Paz and Loreto are home to a number of companies offering crewed trips as well as bareboat sailboat charters. (Several are listed at bajalinks.com.) Mid-October through May offers the best weather, and spring is prime whale-watching season. But even in sweltering September, we found plenty to like about sailing laid-back Baja.





Everyone's Invited

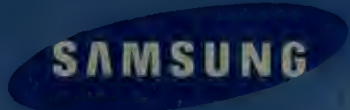
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COMPUSA
WHERE AMERICA BUYS TECHNOLOGY





How to Do Disney

Some simple strategies can make a visit To Orlando actually fun. **BY AMY BORRUS**



VISITING FLORIDA'S Walt Disney World with your kids for the first time is supposed to be fun, fun, fun. But crowds, high prices, and sensory overload can make the vacation seem more like an endurance test. With a little planning, though, you can avoid most of the pitfalls. Here are some tips to help make your family's first visit a blast:

■ **When to go, Part 1** Wait until your youngest child is about 5. Disney's theme parks are relatively tame, but some attractions have loud music and special effects that can scare little ones. Height restrictions for some rides can spark sibling jealousy if some can't join in the fun. Besides, your 3-year-old won't remember the trip by age 6.

FINALLY! In peak season, waits for rides can be as long as 45 minutes

■ **When to go, Part 2** Beat the hordes, hotel rates, and minute waits at popular rides by visiting in the off-season. The best times are a

Thanksgiving through mid-December, January, most of February, after spring break to mid-June, and fall. If you go during a school holiday such as President's Day weekend, arrive Sunday and visit the parks starting Monday, when the crowds thin out.

■ **Why it pays to stay at a Disney resort** Convenience. The efficient Disney bus and monorail system lets you avoid renting a car. But the real draw is that each day one of the four theme parks opens an hour early (8 a.m.) just for Disney resort guests. That means your kid can ride Buzz Lightyear's Space Ranger Spin three times in a row instead of standing in line for 30 minutes at 11 a.m. Check MouseSavers.com, run by Disney aficionado Mary Waring, who started the Web site as a hobby, for promotion codes to use to get discounted rates when calling the Disney center reservations office (407 W-DISNEY). The official site, disneyworld.com, also offers deals.

■ **Get there early** From 8 to 10 a.m., the rides have virtually no waits. So get your brood to the early-opening park of the day by 7:45 a.m., order breakfast via room service. Or request a mini-fridge, pack plastic bowls, spoons, and cereal, and buy milk at the hotel shop.

■ **Schedule downtime** A day at a theme park can be overwhelming. So skip the Cirque du Soleil and other night shows outside the parks. Make time for a midday dip in the hotel pool and for breaks at playgrounds in the parks.

■ **Make advance reservations** Call 407-WDW-DINE at least two weeks ahead (up to 120 days if you're visiting at peak times) to get priority seating for dinner at Disney restaurants. To avoid lining up for an hour to see the Fantasmic! mixed-media show at Disney-MGM Studios, book tickets for dinner before or after the show at Mama Melrose's Ristorante Italiano, Hollywood & Vine, or the Hollywood Brown Derby. They reserve seats for dinner patrons.

CALIFORNIA Napa Arts

In addition to wine tasting, California's Napa Valley offers an array of unique cultural attractions:

The Hess Collection

Anyone with even a passing interest in modern art shouldn't miss this museum-caliber collection, featuring paintings by Frank



"FORKS IN THE ROAD" AT COPIA

Stella, Robert Motherwell, and Francis Bacon (hesscollection.com).

COPIA: The American Center for Wine, Food & the Arts

Foodies will delight in

"Forks in the Road," an exhibit that features kitschy cuisine-related memorabilia (copia.org). **di Rosa Preserve** It houses René and Veronica di Rosa's jaw-dropping collection of more than 2,000 works by local artists (dirosapreserve.org).

Julia Cosgrove



THE HESS COLLECTION



THIS BABY MAY OUTDO ITS PARENT

BY ROBERT BARKER rb@businessweek.com

THE ORPHANS are better off without their parents—corporately speaking, that is. My hunch is this may apply to shares due to coming forth next year from health-care giant Abbott Laboratories. The spring, a new company composed of Abbott's hospital-supply business doesn't even have a name yet.

When it picks one, I won't be surprised if it doesn't take Abbott's, because that name lately has been in bad luck. In 1999, Abbott settled a Food & Drug Administration action by paying \$100 million and agreeing not to sell certain products until it fixed manufacturing problems. Two years later, it flunked a reinspection at a cost of another \$129 million and still awaits the FDA's go-ahead. Abbott had to take a \$274 million charge in 2001 settling yet another probe, this one into sales of Avastin, a prostate-cancer drug. And just last June, it reported earnings of \$622 million after agreeing to plead guilty to obstructing the feds' investigation into how its nutrition products were sold to hospitals and billed to Medicare. The company's rap sheet has done nothing to help Abbott shares, which are now at \$42 from a high last year of \$58. Yet for the hospital-supply company that Abbott is spinning off, the good news is that all of the units that have been getting into trouble will be left behind with the surviving parent, which is keeping the Abbott name. If all goes according to plan, Abbott shareholders will get 100% of the new company's shares at the time in the first half of 2004.

What will they find in their portfolios? A profitable, relatively low-risk company with sales set to grow at perhaps 5% a year. With estimated annual revenue now of \$2.5 billion (table), the new company figures to do a steady business selling such hospital staples as patient-controlled pain-medication-delivery systems, the clot-dissolving drug Abbokinase, and generic anesthetics. Christopher Begley, an Abbott veteran who will be the new company's CEO, told me that after capital spending, it figures to generate \$300 million in cash flow.

ABBOTT'S SPIN-OFF: VITAL SIGNS

Annual Sales	\$2,500
Income	300
Cash Flow	300
Sales Growth Rate	4% to 5%
Competitors	Baxter International, Alaris Medical Systems
Company Name	To be announced

Financial figures are company estimates, in millions. Data: Company reports, BusinessWeek



This would imply a certain market value for the new company, except that a key detail remains blank. Abbott hasn't yet disclosed how much debt it intends to load onto the spin-off. It expects this fall to file papers with the Securities & Exchange Commission that will detail the new company's capital structure. Until then, however, you can estimate some values for the spin-off by looking at how two key public company rivals—Alaris Medical Systems and Baxter International—are regarded by investors today.

With sales of \$496 million over the past four quarters, Alaris is smaller but faster-growing than the Abbott spin-off. Under a total debt load that's nearly nine times its equity, Alaris is also probably much more leveraged than the spin-off will be. At \$17 a share, Alaris' enterprise value—that is, its market capitalization plus net debt—comes to 2.9 times sales and 22 times its free cash flow. Baxter, by contrast, is much bigger, with sales of \$8.4 billion, and has much less debt—just 1.6 times equity. At \$28 a share, it gets 2.6 times sales and a healthy 33 times free cash flow.

What does this suggest for Abbott and its spin-off? Judging by its direct rivals, the spin-off company should command rich multiples of sales and cash flow. At the same time, without its steady, cash-creating hospital-supply operations, Abbott in the future will be more dependent on offier sales of patented drugs and medical devices. In other words, the new Abbott will be potentially faster-growing and more profitable, but decidedly riskier.

Once the spin-off is complete, every Abbott shareholder can choose to keep both stocks or sell one or both. David Jones, co-founder and chairman of health insurer Humana, is set to lead the spin-off's board. In April, he retired from Abbott's board, where at last report he held the most stock among outside directors. That means he stands to become a huge initial shareholder in the spin-off. Yet Jones doesn't intend to stand pat. He told me, "I plan to buy at least 100,000, or maybe 200,000 shares" in the open market. Without the burden of Abbott's baggage, this spin-off could take off. ■



IT COULD BE MERGER TIME FOR SPANISH BROADCASTING SYSTEM IMAGISTICS INTERNATIONAL LOOKS LIKE BAIT TO SOME IN JAPAN SARBANES-OXLEY MAY SOON SPARK UP INTERWOVEN SOFTWARE

BY GENE G. MARCIAL

Tuning In to SBSA

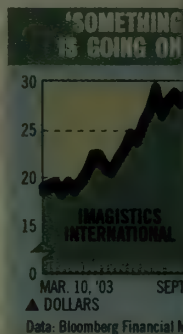
Spanish Broadcasting System (SBSA), No. 2 in revenues among Spanish-language radio outfits, may have buyers dialing its number—now that Univision's proposed purchase of Hispanic Broadcasting is expected to get a government thumbs-up soon. SBSA and Hispanic were quietly talking merger last year—before Univision came along to buy Hispanic in June, 2002. SBSA tried to block the deal but failed. And two years ago, Telemundo, also big in Spanish radio, wanted Miami-based SBSA—until NBC snatched Telemundo away. Now, with Univision-Hispanic set to be No. 1, Telemundo and Viacom are expected to go after SBSA to compete with the combo powerhouse, says David Joyce of investment bank Guzman. NBC won't let Telemundo fall behind, and surely Viacom will want its Infinity Broadcasting unit, which operates 185 stations, to prevail in the fast-growing Spanish market, he adds. SBSA owns 23 radio stations in big cities—including Los Angeles, New York, Miami, and Chicago—that reach about 51% of the Hispanic population, notes Joyce. To go after SBSA, suitors will have to win over CEO Raúl Alarcón Jr., who has 86% voting control. Joyce thinks Alarcón may go for a deal at 20 a share. Based on cash flow, the stock, which has run up from 5 in early March to 8.23 on Sept. 10, is worth 13, figures Joyce. Kit Spring of securities outfit Stifel Nicolaus, which did banking for SBSA, rates the stock a buy. Spring sees cash flow of \$46 million in 2003 and \$59 million in 2004, and forecasts earnings of 9¢ a share in 2003 and 19¢ in 2004, vs. a loss in 2002. SBSA declined comment.



A Sharper Focus On Imagistics?

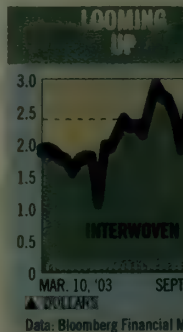
When Imagistics International (IGI) was featured here on Aug. 26, 2002, it was trading at 18.95 a share. It has since jumped to 29.55—thanks to improving gross margins and better operating income, in spite of the soggy economy. That has made Imagistics—which supplies copiers, faxes, and multifunctional machines to large corporations—an attractive takeover candidate, says Shannon Cross of Soleil Securities, who rates the stock a buy. Japan's Ricoh, Sharp, and Toshiba, which supply Imagistics with customized imaging

products, are known to be impressed with the company's sales marketing prowess, notes Cross. Her 12-month target is 35, "but obviously a buyer will have to pay a premium in a buyout," she says. Cross recently raised her 2003 earnings estimate from \$1.11 to \$1.15 a share on sales of \$620 million, and her 2004 forecast from \$1.37 to \$1.41 on \$626.4 million. Herbert Hardt of investment firm Monness, Crespi, Hardt says "something is going on" from the way the stock has rocketed on heavy volume. CEO Marc Breslawsky couldn't be reached for comment on whether a suitor has approached him for a buyout deal.



At Interwoven, Things are Meshing Nicely

Savvy hedge funds have been snapping up Interwoven (IWOV) shares in anticipation of the enforcement in 2004 of the Sarbanes-Oxley Act, aimed at improving the way companies manage and report financial information. The law requires companies to set in place internal controls and auditing safeguards to prevent accounting fraud. It would be a boon to Interwoven, says New York hedge fund manager, who asked not to be identified. Interwoven's software automates the collation and reporting of financial information, especially in documenting earnings results. Currently at 2.90, Interwoven is down from its high of 62 in 2000. It has cash of \$1 a share and no debt. This pro sees the stock doubling in a year: He expects the company to be in the black by the fourth quarter—although it will post a yearly loss for 2003. In 2004, he foresees earnings of 4¢ to 5¢ a share. In August, Interwoven acquired iManage, a maker of data-management software. The buy improves Interwoven's ability to compete against big rivals, says David Rudow of U.S. Bancorp Piper Jaffray, who rates the stock outperform. He projects a loss of 16¢ a share in 2003 on sales of \$108 million and a loss of 4¢ in 2004 on \$118 million, including iManage's numbers.



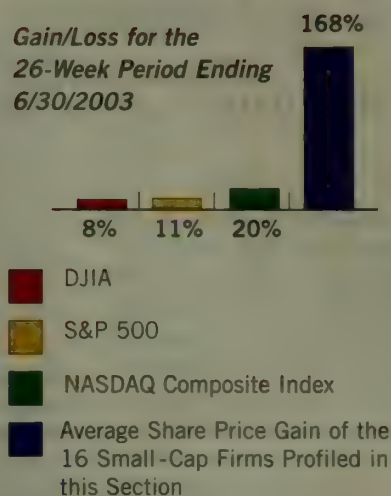
BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. the magazine's publication day, usually Thursdays. See Gene on Fridays 1:20 p.m. EST on CNNfn's *The Money Gang*.

Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with the

THE EQUITY INVESTOR'S 26-WEEK SMALL-CAP REVIEW

SELECTED PROFILES OF THE NATION'S TOP PRICE-PERFORMING SMALL-CAP COMPANIES AS OF 6/30/03

From approximately 1,700 domestic companies with market capitalizations of 200 million to one billion dollars, the following pages highlight selected top-ranking firms, in terms of share price performance for the 26-week period ending 6/30/03. Each profile describes a leading company including its industry, market trends and reasons for success, as written by company management. And while past performance is never a guarantee of future results, these top-performing companies represent investment opportunities worthy of a small-cap investor's close consideration.



Finisar Corporation • FNSR • Network Technology

Sunnyvale, CA • IR Contact: Shelby Palmer • 408-542-5050
www.finisar.com

Finisar

Founded in 1988, Finisar Corporation is a technology leader for fiber optic systems and network performance test and monitoring systems that enable speed data communications over local area networks (LANs), storage area networks (SANs), and metropolitan access networks (MANs). The company has produced a number of breakthrough products incorporating disruptive technology over the years including the first cost effective one gigabit optical transceiver for Fibre Channel SANs, the use of CWDM and DWDM technologies for scalable high-bandwidth MANs and the use of the XFP small form factor for gigabit Ethernet applications. The company sells its optical subsystems to storage and networking equipment manufacturers while test and monitoring systems are sold to both OEMs and operators in storage and networking data centers.



SeaChange International, Inc. • SEAC • Digital Video

Maynard, MA • IR Contact: Martha Schaefer • 978-582-9051
www.schange.com

SeaChange

Video-on-demand (VOD) is quietly sweeping across North America and SeaChange is at the forefront of this "personal television" revolution. AOL Time Warner, Cablevision, Comcast and others are rolling-out SeaChange systems so viewers can watch what they want — when they want it.

The Company has developed an integrated platform of sophisticated software and hardware for television applications — including VOD, targeted multichannel advertising, on-air broadcasting, and High-Definition TV. Worldwide, television companies, networks and broadcasters are leveraging SeaChange's intelligent media systems to gain new advantages in the evolution of digital video.

The Emmy Award-winning Company had \$133 million in revenues in 2003 FY and had been named earlier to *BusinessWeek's* Hot Growth list. President and CEO Bill Styslinger founded the company in 1993. With a reputation for technological excellence and a keen service emphasis, SeaChange is the formidable front-runner in the emerging digital video market.

Sirna Therapeutics • RNAi • Biotechnology

Cambridge, MA • IR Contact: Marvin Tancer, CFO, VP Operations • 303-449-6500
www.sirna.com

Sirna Therapeutics

Sirna Therapeutics (NASDAQ: RNAI) is a leading developer of therapeutics based on RNA interference (RNAi) technology. Sirna is leveraging its proprietary technology and expertise in nucleic acids to develop RNAi-based molecules that actively target disease-causing genes and viruses. Its researchers are currently focused on designing, stabilizing and delivering RNAi-based drugs for the treatment of hepatitis C and targeting the Vascular Endothelial Growth Factor (VEGF) pathway to treat age related macular degeneration, a leading cause of blindness among the elderly. Sirna is currently pursuing other disease indications and is committed to expanding its RNAi-based product portfolio.

Key Manager Statement

"With extensive scientific expertise in RNA chemistry and biology, a strong intellectual property portfolio and the funding in place to move its programs forward, Sirna is in a leadership position to develop this new and exciting technology."

Howard W. Robin, CEO

Natural Resource Partners L.P. • NRP • Coal Royalties

Houston, TX • IR Contact: Kathy Hager • 713-751-7555
www.nrplp.com

NRP

Natural Resource Partners L.P. is a master limited partnership that is principally engaged in the business of owning and managing coal properties in the three major coal producing regions of the United States: Appalachia, the Illinois Basin and the Powder River Basin. The company leases coal reserves to experienced mine operators under long-term leases that grant the operators the right to mine NRP's coal reserves in exchange for royalty payments. Approximately 80% of the coal produced by the company's lessees is used for the generation of electricity, while 20% is used in the production of steel. NRP is headquartered in Houston, TX, with its operations headquarters in Huntington, WV.

Key Manager Statement

"Our goal is to generate superior returns for our unitholders through increasing both the value of the partnership and distributions. Since our initial public offering in October 2002, we have made four accretive acquisitions and increased our distribution. We plan to continue our growth strategy by making additional accretive acquisitions."

Corbin J. Robertson, Jr.,
Chairman & CEO

THE EQUITY INVESTOR'S 26-WEEK SMALL-CAP REVIEW

PRIMUS Telecommunications Group, Inc. • PRTL • Telecom

McLean, VA • IR Contact: John F. DePodesta • 703-902-2800
www.primustel.com



PRIMUS Telecommunications Group, Incorporated is a global telecommunications service provider with over \$1.2 billion in annualized revenue and targeted earnings per share of between \$.38 and \$.42 in 2003. PRIMUS offers an integrated portfolio of voice, data, Internet, VoIP and hosting services to corporate, small- and medium-sized businesses and residential customers primarily located in North America, Western Europe and Australia.

Key Manager Statement

"PRIMUS is the only global Tier 2 telecom company to survive the volatile events that have impacted the telecom industry since 2000. The keys to our success have been the ability to reduce debt by over 60%, increase profits from operations ten-fold over this same period and secure additional equity financing. We are uniquely positioned to grow in each of our core markets and become a platform for consolidation. PRIMUS is targeting revenue growth of approximately 25% in 2003 over the prior year. Our mission has always been to provide our stakeholders with superior returns on their investment."

ILEX™ Oncology, Inc. • ILXO • Biopharmaceuticals

San Antonio, TX • IR Contact: Craig A. Tooman • 210-949-8417
www.ilxonc.com



ILEX™ Oncology is a biopharmaceutical company focused on developing and commercializing a portfolio of novel therapeutic treatments, primarily in oncology (cancer). Its lead product, CAMPATH®, is marketed by Schering AG, Germany and its U.S. affiliate Berlex Laboratories for the treatment of patients with the most prevalent form of adult leukemia. The potential use of CAMPATH in other cancers, organ transplantation and multiple sclerosis is being actively explored. ILEX is also advancing two other next-generation compounds with potential in the large solid tumor market.

Key Manager Statement

"ILEX is one of a select group of biopharmaceutical companies with a marketed product. The unfolding story of CAMPATH is one of solid growth, with significant opportunities both in oncology and non-oncology. Meanwhile, the rest of our pipeline is progressing nicely with a continuous flow of new data as the compounds advance to later stages of development. We remain focused on our vision of turning hope into reality for patients by bringing these key medical advances to market."

Jeffrey H. Buchalter,
President & CEO

chinadotcom corporation • CHINA • Software, Internet

Hong Kong, China • IR Contact: Craig D. Celek • 212-661-2160
corp.china.com



chinadotcom corporation is a leading integrated enterprise solutions and software company offering technology, marketing, mobile and media services for companies throughout Greater China, Asia-Pacific, US and UK.

chinadotcom's core business includes:

1) **Software & Outsourcing** focus is proprietary software in payroll, human resources and financial systems and establishing partnerships with leading software vendors; as well as high-level enterprise solutions and low-cost application outsourcing centres in China and India. 2) **CDC Mobile and Portals** offers consumer-based SMS, mobile application software development and consumer portals in the Greater China region.

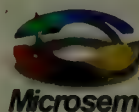
Key Manager Statement

"chinadotcom is focused on the long-term opportunities presented by Greater China's continuing economic development and its needs in information technology, mobile and media services. We believe this is an opportune time for making synergistic acquisitions, thus shaping a strong company that is sustainably profitable with high-margins and recurrent revenue streams."

Peter Yip, CEO

Microsemi Corporation • MSCC • Semiconductors

Irvine, CA • IR Contact: David R. Sonksen, CFO • 949-221-7101
www.Microsemi.com



Microsemi Corporation is a leading manufacturer of analog mixed-signal and discrete semiconductors that manage, regulate power, protect against voltage spikes, and transmit and receive and amplify signals.

Markets the company serves include space/satellite and military, mobile connectivity, computer/peripherals, medical, industrial, automotive and digital media.

Microsemi products enhance customer designs by improving reliability, battery optimization, reducing size or protecting circuits. Focus is on discrete devices and modules for military/aerospace systems, pacemakers, MRI systems, implantable cardio defibrillators; and integrated circuits for PDAs, wireless LAN, automotive GPS and entertainment displays.

Key Manager Statement

"Microsemi's business fundamentals are strengthening. Our positive bottom-to-bill continues. Our Factory Utilization and Profit Enhancement program proceeding on plan and delivering results. Our high reliability military and medical products are in high demand and we continue to develop and gain sockets with our next generation power management products."

James J. Peterson, President & CEO

Exult, Inc. • EXLT • Human Resources

Irvine, CA • IR Contact: Peter Hargittay • 714-856-6873
www.exult.net



EXULT®

Exult, Inc. is the market leader and innovator in Human Resources-led Business Process Outsourcing (HR-led BPO). Global 500 corporations, with headquarters in Irvine, California, and client service centers in North America, South America, Europe, and Asia. Through its proprietary Exult Service Delivery Model™, Exult offers comprehensive, scalable process management solutions, designed to manage clients' Human Resource and related Finance & Accounting and Procurement functions. Exult uses its expertise to help Global 500 corporations improve productivity, reduce costs, streamline processes and provide superior HR services to their employees.

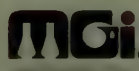
Key Manager Statement

"When we founded Exult in 1998, we set out to pioneer an entirely new way of approaching HR. Recognizing the challenges facing Global 500 companies, we developed a method of delivering HR-related services that would transform the quality, service, and cost structure for companies worldwide. Today, HR-led BPO is viewed as the fastest growing segment of HR services — and Exult is recognized as the industry leader and innovator."

Jim Madden,
Founder, CEO & Chairman

MGI PHARMA, INC. • MOGN • Biopharmaceutical

Bloomington, MN • IR Contact: Jennifer M. Davis • ir@mgi-pharma.com
www.mgi-pharma.com



MGI PHARMA, INC. is an oncology-focused biopharmaceutical company that acquires, develops and commercializes proprietary products that address the unmet needs of cancer patients. MGI has a balanced product portfolio of proprietary pharmaceuticals and intends to become a leader in oncology. The company markets Aloxi™, a drug developed for the prevention of chemotherapy-induced nausea and vomiting (CINV). Aloxi, which was approved by the U.S. Food and Drug Administration on July 25, 2001, is the first 5-HT3 receptor antagonist to be indicated for the prevention of delayed CINV caused by moderately emetogenic cancer chemotherapy. The company also markets Salagen® Tablets (pilocarpine hydrochloride) and Hexalen® (almitrine) capsules. The company directly markets its products in the U.S. and collaborates with various alliances in international markets.

Key Manager Statement

"We believe Aloxi™ is a differentiated supportive care product, with great potential to help cancer patients undergoing chemotherapy. MGI looks forward to making Aloxi available in September to clinicians and their patients."

Lonnie O. Moulder, President & CEO

THE EQUITY INVESTOR'S 26-WEEK SMALL-CAP REVIEW

Bentley Pharmaceuticals, Inc. • BNT • Pharmaceuticals

Exeter, NH • IR Contact: Michael Price, VP, CFO • 603-658-6100
www.bentleypharm.com



Bentley Pharmaceuticals, Inc. uses its advanced drug delivery technologies to enhance or facilitate the absorption of pharmaceuticals across biological membranes.

It develops proprietary drugs, licenses its technologies, and collaborates with companies like Pfizer and Auxilium Pharmaceuticals. It manufactures and markets generic and branded pharmaceuticals in Europe and has an alliance with Pharmaceuicals to register and market approximately 75 of Teva's products in the U.S. Bentley plans to develop and commercialize drugs in other markets worldwide including the U.S. For the six months ended June 2003, total revenues grew 67% over the comparable prior year period.

Key Manager Statement

"We are strategically and financially positioned for success. Our strong financial results reflect growth from our European operations, where we have 59 product registrations pending approval and licensees in place in Portugal, the U.K., France and Germany. Testim™, the first U.S. product containing our CPE-215 technology, was launched by Auxilium this year."

**James R. Murphy, Chairman,
President & CEO**

Omniceil, Inc. • OMCL • Healthcare I.T.

Palo Alto, CA • IR Contact: Dennis Wolf • 650-251-6482
www.omnicell.com



Established in 1992, Omnicell, Inc. (NASDAQ: OMCL) is a leading provider of patient safety solutions for healthcare. Addressing the medication

use process and the medical-surgical supply chain, Omnicell's broad range of solutions include systems for automated medication retrieval, bar code medication management, medication and supply dispensing, nursing workflow automation at the bedside, physician order management, and Web-based procurement. These solutions enable healthcare facilities to reduce medication errors, operate more efficiently, and decrease costs—significantly contributing to improved clinical and financial outcomes.

Key Manager Statement

"Omnicell's solutions address the major issues confronting healthcare today: rising costs, the nursing and pharmacist shortages, and concerns about patient safety. With expanded product offerings, today our company serves markets that total \$15 billion. Omnicell enjoys a large, highly satisfied installed base, a solid balance sheet, profitable operations, and excellent future growth prospects."

Randall A. Lipps, Chairman & CEO

Time Warner Telecom Inc. • TWTC • Telecommunications

Littleton, CO • IR Contact: Carole Curtin • 303-566-1000
PR/Media Contact: Bob Meldrum • 303-566-1354 • www.twtelecom.com



DRIVING YOUR NETWORK

Time Warner Telecom Inc., (Nasdaq: TWTC), is a leading provider of competitive telecommunications products and services to large and medium businesses in 44 U.S. metropolitan areas. The company delivers "last mile" broadband services, including voice, data, metro Ethernet and high speed Internet access, over its own local and regional optical networks. The uniqueness of Time Warner Telecom's offer is its focus on serving cities with fiber networks that deliver service all the way to the customer's premise. A truly competitive alternative to the local phone company, Time Warner Telecom serves a variety of businesses including telecom carriers; enterprise customers in industries like financial, healthcare, higher education, and hospitality; and military and government organizations. Time Warner Telecom has a strong financial position including seventeen consecutive quarters of positive EBITDA.

Epicor Software Corporation • EPIC • Enterprise Software

Irvine, CA • IR Contact: Valerie Brodie, Senior Director Investor Relations
www.epicor.com • vbrodie@epicor.com



For 20 years, Epicor Software has been a recognized leader dedicated to providing award-winning enterprise software to the midmarket. Epicor has extended the value of its enterprise software solutions with fully integrated functionality including eBusiness, commerce, business intelligence, information portals, services automation, help desk, customer relationship and supplier relationship management. Epicor has over 15,000 customers worldwide, and leverages its expertise with tailored solutions for manufacturing, distribution, services, and hospitality. Through global service and support teams, Epicor offers enterprise-wide solutions with a single point of accountability to deliver a clear and rapid rate of return on investment and a low total cost of ownership.

Key Manager Statement

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**George Klaus,
Chairman, CEO & President**

Flowers Foods • FLO • FOOD

Thomasville, GA • IR Contact: Marta J. Turner • 229-227-2348
www.flowersfoods.com



FlowersFoods

With sales of over \$1.4 billion, FLO is a leading producer of packaged bakery products. The company's breads, buns, rolls, cakes, and pastries for retail and service customers are distributed nationwide via an independent direct-store-delivery system and frozen through warehousing programs. Flowers' brands include Mrs. O's Own, Cobblestone Mill, and Mrs. Woodward's.

Key Manager Statement

"Our long term strategies—investment in our bakeries, products, brands, acquisitions, distribution systems, and information technology—set us apart from others in the baked goods industry. We expect Flowers' operational and financial strengths to result in enhanced shareholder value."

Jimmy Woodward, CFO

Sharper Image Corporation • SHRP • Specialty Retail

San Francisco, CA • IR Contact: Jeff Forgan • 415-445-6142
www.sharperimage.com



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Key Manager Statement

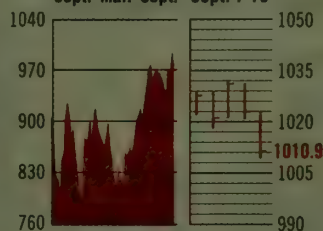
"Our strategy focuses on building on our strong brand name; marketing high-margin proprietary products; and making it easy for customers to shop our stores, catalog and Website. One of the industry's top analysts wrote 'Sharper Image is the best multichannel retailer.' We are focused on broadening our appeal to a larger consumer base and we are well positioned for accelerated top- and bottom-line growth."

**Richard Thalheimer
Founder, Chairman & CEO**

STOCKS

S&P 500

Sept. Mar. Sept. Sept. 4-10

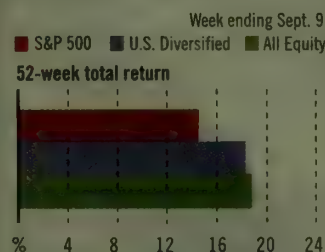
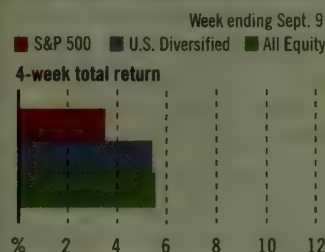


COMMENTARY

Equities gave up ground this week, despite the absence of bad economic news. Some attributed the decline to a new threatening tape from al Qaeda head Osama bin Laden, while others pointed to a weakness in tech, namely Nokia warning that revenues will be at the low end of estimates. The likely reason: Buyers are hedging bets into a new earnings season.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS



Data: Standard & Poor's

U.S. MARKETS

	SEPT. 10	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1010.9	-1.5	14.9	11.1
Dow Jones Industrials	9420.5	-1.5	12.9	9.5
NASDAQ Composite	1823.8	-1.6	36.6	38.2
S&P MidCap 400	514.8	-2.1	19.8	15.6
S&P SmallCap 600	243.6	-2.1	23.9	20.0
Wilshire 5000	9794.4	-1.5	17.4	13.7

SECTORS

	SEPT. 10	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	581.6	-0.9	7.2	1.9
BW Info Tech 100**	318.8	-1.5	11.7	15.4
S&P/BARRA Growth	515.3	-1.0	14.8	9.9
S&P/BARRA Value	492.2	-2.0	15.0	12.5
S&P Energy	200.7	-0.8	9.6	7.6
S&P Financials	339.1	-2.1	14.2	10.2
S&P REIT	105.5	-1.8	16.2	10.2
S&P Transportation	178.1	-2.0	4.8	4.3
S&P Utilities	108.8	0.1	11.3	7.2
GSTI Internet	134.0	-0.3	79.4	91.9
PSE Technology	630.7	-1.9	37.6	39.5

*Mar. 19, 1999 = 1000 **Feb. 7, 2000 = 1000

BEST-PERFORMING GROUPS

Group	LAST MONTH %	LAST 12 MONTHS %
Electric Mfg. Svcs.	20.7	Internet Software 229.9
Tires & Rubber	19.7	Wireless Services 97.6
Internet Software	19.2	Comptr. Stge. & Perphs. 88.0
Semiconductors	18.7	Divsfd. Metals & Mining 83.7
Comptr. Stge. & Perphs.	18.3	Internet Retailers 71.9

EQUITY FUND CATEGORIES

Category	4-WEEK TOTAL RETURN %	52-WEEK TOTAL RETURN %
LEADERS		
Technology	14.7	Technology 49.8
Japan	13.5	Precious Metals 39.2
Precious Metals	12.5	Communications 38.7
Diversified Pacific/Asia	10.5	Latin America 32.5
LAGGARDS		
Financial	2.0	Miscellaneous 10.4
Utilities	2.7	Domestic Hybrid 10.6
Domestic Hybrid	2.8	Large-cap Value 12.5
Large-cap Value	3.0	Large-cap Blend 12.5

EQUITY FUNDS

Fund	4-WEEK TOTAL RETURN %	52-WEEK TOTAL RETURN %
LEADERS		
PFds. Smicdr. Ultsr. Inv.	33.3	PFds. Intnet. Ultsr. Inv. 182.9
Reynolds	26.5	Jacob Internet 165.0
Rydex Electronics Inv.	23.4	RS Internet Age 113.6
ProFunds UltraOTC Inv.	21.5	Apex Mid Cap Growth 107.2
LAGGARDS		
PFds. Ultsr. OTC Inv.	-18.5	Frontier Equity -64.5
Rydex Dynam. Vent. 100	-18.5	Rydex Dynam. Vent. 100 -64.4
Potomac OTC/Short Inv.	-9.9	PFds. Ultsr. OTC Inv. -64.3
ProFunds Short OTC Inv.	-9.7	Potomac OTC/Short Inv. -38.9

GLOBAL MARKETS

	SEPT. 10	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	985.2	0.4	16.7
London (FT-SE 100)	4252.1	-0.2	7.9
Paris (CAC 40)	3328.7	-2.7	8.6
Frankfurt (DAX)	3536.9	-3.0	22.3
Tokyo (NIKKEI 225)	10,856.3	1.3	26.5
Hong Kong (Hang Seng)	10,810.3	-2.6	16.0
Toronto (S&P/TSX Composite)	7571.1	-0.1	14.5
Mexico City (IPC)	7734.7	0.2	26.2

FUNDAMENTALS

	SEPT. 9	WEEK AGO
S&P 500 Dividend Yield	1.62%	1.62%
S&P 500 P/E Ratio (Trailing 12 mos.)	28.7	28.7
S&P 500 P/E Ratio (Next 12 mos.)*	16.7	17.2
First Call Earnings Revision*	0.46%	0.02%

TECHNICAL INDICATORS

	SEPT. 9	WEEK AGO
S&P 500 200-day average	924.2	921.8
Stocks above 200-day average	82.0%	81.0%
Options: Put/call ratio	0.65	0.76
Insiders: Vickers NYSE Sell/buy ratio	4.69	4.29

WORST-PERFORMING GROUPS

Group	LAST MONTH %	LAST 12 MONTHS %
Homebuilding	-5.3	Health-Care Facilities -3
Banks	-4.0	Tires & Rubber -3
Specialty Appar. Retailers	-3.1	IT Consulting -1
Health Care Equipment	-2.3	Housewares & Specialties -1
Multi-line Insurers	-2.2	Tobacco -1

INTEREST RATES

KEY RATES

	SEPT. 10	WEEK AGO	YEAR
MONEY MARKET FUNDS	0.61%	0.62%	1.3
90-DAY TREASURY BILLS	0.94	0.97	1.6
2-YEAR TREASURY NOTES	1.63	2.00	2.1
10-YEAR TREASURY NOTES	4.27	4.50	4.0
30-YEAR TREASURY BONDS	5.16	5.35	4.8
30-YEAR FIXED MORTGAGE†	6.43	6.49	6.2

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
GENERAL OBLIGATIONS	3.94%	4.8
TAXABLE EQUIVALENT	5.63	6.8
INSURED REVENUE BONDS	4.06	4.9
TAXABLE EQUIVALENT	5.80	7.1

THE WEEK AHEAD

CURRENT ACCOUNT Monday, Sept. 15, 8:30 a.m. EDT ► The U.S. current account deficit is forecast to have reached \$138 billion in the second quarter.

INDUSTRIAL PRODUCTION Monday, Sept. 15, 9:15 a.m. EDT ► August factory output probably rose by 0.1%. That's based on the median forecast of economists surveyed by MMS International. The average operating rate most likely held at 74.5%.

CONSUMER PRICE INDEX Tuesday, Sept. 16, 8:30 a.m. EDT ► Consumer prices for

goods and services in August probably moved up 0.3%. Minus food and energy, core prices most likely climbed 0.2%.

FOMC MEETING Tuesday, Sept. 16, 9 a.m. EDT ► The Federal Reserve Board's Open Market Committee meets to set monetary policy. Every economist surveyed by MMS International believes the Fed will keep the federal funds rate at 1%.

NEW RESIDENTIAL CONSTRUCTION Wednesday, Sept. 17, 8:30 a.m. EDT ► Housing starts in August are expected to have eased to an annual rate of 1.83 million.

LEADING INDICATORS Thursday, Sept. 18, a.m. EDT ► The Conference Board's Aug. leading indicators index likely rose 0.3%.

The *BusinessWeek* production index climbed the week ended Aug. 30 to 199.2, up 3.8% from a year ago. Before calculation of the four-week moving average, the index rose to 200.7.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra.htm

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COMPLIANCE WEEK

Index to Companies

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

A

Abbott Laboratories (ABT) 131
Able Manufacturing & Assembly 36
Adelphia Communications (ADLAC) 80
AirTran Holdings (AAI) 40
Alaris Medical Systems (AMI) 131
American Airlines (AMR) 40
American Express (AXP) 121
American Standard (ASD) 12
Amrad 74
AOL Time Warner (AOL) 12
Aspen Grove Capital 112
AstraZeneca (AZN) 40
AT&T (T) 74

B

Baja Coast SeaFaris 128
Banc of America Securities (BAC) 28
Bank of America (BAC) 106
Bank One (ONE) 106
BASF (BASFY) 74
Baxter International (BAX) 86, 131
BearingPoint (BE) 50
Bedlam Entertainment 119
Biogen (BGEN) 86
Boston Consulting Group 90
Boston Scientific (BSX) 36, 86
Business Objects (BOBJ) 68

C

Cambria Consulting 90
Canary Capital Partners 106, 112, 140
Capital One Financial (COF) 42
Capitol Broadcasting 66

Cathay Pacific Airways

121
CBS (VIA) 66
CDW (CDWC) 36
Charles Schwab (SCH) 114
Chelsea Football Club 63
Citigroup (C) 90, 98
Coca-Cola (KO) 16
Continental Airlines (CAL) 40
Cordis (JNU) 86
Crédit Lyonnais 46
Crédit Suisse First Boston (CSR) 80

D

Da Afghanistan Bank 50
DaimlerChrysler (DCX) 38, 40
Davis Selected Advisors 80
Dell (DELL) 20, 98
Deloitte & Touche 80
Did-It.com 119
Dow Chemical (DOW) 74
Dr. Koop LifeCare 90
Dunkin' Donuts 90

E

Eaton Vance (EV) 12
Eisai 16
Electronic Data Systems (EDS) 36
Eli Lilly (LLY) 74
Enron (ENRNQ) 16, 42, 80
Epson 20
Expedia (EXPE) 12

F

Fannie Mae (FNM) 42
Fidelity Investments 80, 106
First Microfinance Bank 50
Ford (F) 38
Forrester Research (FORR) 106
Fox Entertainment (FOX) 66
Freddie Mac (FRE) 42, 80
FundExpress.com 106

G

GameSpy Industries 90
Gannett (GCI) 66
GEGA IT-Solutions 68
Genentech (DNA) 36, 42
General Motors (GM) 38, 40
Goldman Sachs (GS) 28, 80
Grove Farm 12
Guinness Atkinson Funds 106
Guzman 132

H

Healthcare Underwriters Group of Florida 12
HealthSouth (HRC) 80
Hewlett-Packard (HPQ) 20
Hilton (HLT) 12
Hispanic Broadcasting (HSP) 132
Honda (HMC) 38
Humana (HUM) 131
Hyatt 12
Hyperion Solutions (HYSL) 80

I

IBM (IBM) 74, 132
IDC (IDC) 68
IIB Bank 46
Imagistics International (IGI) 132
iManage (IMAN) 132
ImClone Systems (IMCL) 80
Industrial Research Institute 74
InFocus 20
Infote (INFTE) 66
Intel (INTC) 74
InterContinental Hotel Group 12
International Paper (IP) 42
Interpublic Group (IPG) 40
Interwoven (IWOV) 132
Investment Company Institute 80

J

Janus Capital 106
J.D. Power & Associates 36
JetBlue Airways (JBLU) 40
Johnson & Johnson (JNJ) 86
J.P. Morgan Chase (JPM) 36

K

KPMG 80

L

Legg Mason Funds Management 80
Lihue Plantation 12
Lipper 106
LiquidNet 106
Logitech International (LOGI) 68

M

Manchester United 63
Manpower (MAN) 36
Marriott (MAR) 12
Maui Land & Pineapple (MLP) 12
Media General (MEG) 66
Medinol 86
Medtronic (MDT) 80, 86
Merck (MRK) 74
Merrill Lynch (MER) 80, 86, 114
Microsoft (MSFT) 68, 74, 98, 132
Monness Crespi Hardt 132
Moody's Investors Service (MCO) 36
Morgan Stanley (MWD) 38, 80

N

National Bank of Pakistan 50
National Union 80
NBC (GE) 132
NEC (NIPNY) 20
Ned Davis Research 114
Network Associates (NET) 36
Nielsen/NetRatings 12
Northwest Airlines (NWAC) 40, 90, 121

Novartis (NVS) 80

O

Openwave Systems 90
Oracle (ORCL) 132
Orbitz.com 12

P

Panera Bread 98
PerkinElmer (PKI) 40
Pfizer (PFE) 16, 80
PhoCusWright 12
Phoenix Wealth Management/Harris Interactive 119
PricewaterhouseCoopers 80
Procter & Gamble (PG) 74
Prudential Securities (PRU) 12, 80, 106
Public Financial Management 98
Putnam Investments (MMC) 106

Q

Qwest Communications International (Q) 36

R

Rayovac (ROV) 119
Raytheon (RTN) 36
Ricoh (RICOY) 132
Rosenbluth International 40
Rx Depot 42

S

Saegis Pharmaceuticals 16
Salomon Smith Barney (C) 80
Sanford C. Bernstein 90
Sapient 48
Schering-Plough (SGP) 42
SCPIE Holdings 12
Sempra Energy 80
Sharp (SHCAY) 132
Smith Barney (C) 90
Société Générale 46
Soleil Securities 132
Southwest Airlines (LUV) 40

Spanish Broadcasting System (SBSA) 132
Sprint (FON) 80
Standard Chartered Bank 50

Starwood (HOT) 12
Stifel Nicolaus 132
Strike Holdings 98
Strong Capital Management 106
Sun Microsystems (SUNW) 42
Sunnyside Farms 12
Symantec (SYMC) 68

T

Target (TGT) 80
Telemundo 132
Thomson First Call 12, 80, 114
Toshiba (TOSBF) 20
Toyota (TM) 38
Travelweb 12
Trend Micro (TMIC) 68
Tribune (TRB) 66
T. Rowe Price 106
24/7 Customer 68
Tyco International (TYCO) 80

U

United Airlines (UAL)
Univision Communications (UNIV)
132
U.S. Bancorp Piper Jaffrey (USB) 132
Utilities International

V

Vanguard Group 80, 114
Viacom (VIA) 132
Victory Capital Management 114

W

Walt Disney (DIS) 90
Wasatch Advisors 106
Wipro (WIT) 68
WorldCom 80
Wyeth (WYE) 86

X

Xerox (XRX) 74, 80

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THE BUDGET: MAKE THE TOUGH CHOICES

Iraq's impact on the budget deficit is starting to unhinge Washington. President George W. Bush's surprise announcement that he will ask for \$87 billion in new money to fund operations in Iraq for fiscal 2004 means the deficit will shoot past \$500 billion next year, heading toward a staggering \$600 billion. Total budget deficits for the next 10 fiscal years, from 2004 through 2013, may be pushing \$6 trillion or more. The final total depends in part on whether Washington can cut a deal in the U.N. to bring in European, Asian, and Middle Eastern countries to share the financial burden of reconstructing Iraq. The budgetary clock is running: The deficit is already approaching 5% of gross domestic product, a key political trigger point. The last time this happened, back in 1992, Congress was pressured to institute caps on discretionary spending. This time around, spending caps may not be enough. None of the choices ahead will be easy, but choices must nevertheless be made (page 36).

Certainly a strong recovery and a rising stock market will increase tax revenues. Today, federal tax revenues as a share of GDP are down to 16%, a 50-year low. They are sure to rise. But even the Congressional Budget Office, which is now led by a supply-sider, agrees that there is no way that the recent tax cuts can pay for themselves. The hope that "dynamic scoring" will solve the problem of making choices is gone. Higher economic growth won't generate enough revenues to balance the kind of budget deficits we see developing today.

The Baby Boom generation will start retiring in earnest in seven years, putting a huge drain on government finances precisely when the budget deficit is soaring. This means making choices is essential as the decade progresses. Some 80% of the budget is already cordoned off in nondiscre-

tionary spending for Social Security, Medicare, military outlays, homeland security, and interest payments on the federal debt. The rest goes for highways, education, farm subsidies, national parks, and numerous other things. Reining in the budget is all about what you get, what you give up, who benefits, who doesn't.

What is on the table? As the deficit mounts, there will be pressure to phase out the cuts in income and inheritance tax as scheduled and not make them permanent, postpone the alternative minimum tax (AMT), back-burner the cut in the corporate-tax rate, reduce the Medicare prescription drug benefit, and curb discretionary spending for highways, education, parks, and health. The cost of fixing the AMT alone is about \$400 billion over 10 years. The drug benefit comes at about \$400 billion. And making the 2001 income tax cut permanent will amount to \$1.6 trillion over a decade. Something will have to give.

There are already indications that the White House and congressional leaders are trying to avoid making the hard choices by treating the request for an additional \$87 billion for Iraq as if it were off-budget spending. This would allow them to not count it as part of the budget total. It's politics as usual in Washington, played by both political parties with vested stakes in their own partisan programs. And it epitomizes the failure of the nation and its political leaders to make the difficult choices needed if America is to avoid strangling its future prosperity on higher interest rates and burdening its children with enormous debts. Washington should reject the temptation to cheat on the budget, and the public should stop denying what is painfully clear. The time for choosing what people want and what they can afford is drawing very near.

RESTORING TRUST IN MUTUAL FUNDS

It's time for the wholesale reform of the nation's mutual-fund industry. New York State Attorney General Eliot Spitzer has revealed that big fund companies gave special breaks to a hedge-fund manager that were not available to average investors and that may, in fact, have been detrimental to their interests. Canary Capital Partners settled with Spitzer by paying \$30 million in restitution and, in addition, a \$10 million fine—without admitting guilt (try explaining that to your children). This is by no means the first time that small investors have gotten the short end of the stick from mutual funds. They've been suffering for years, and it's got to stop (page 106).

Excessive costs, high fees, and high compensation paid to mutual-fund managers regardless of performance have been seriously eroding investor returns for far too long. Investors even have to pay fees for funds' marketing and advertising

costs under the infamous 12(b)-1 rule. This is simply absurd.

What is needed above all is for the Securities & Exchange Commission and the funds' own trustees to step up to their responsibilities. Putting a stop to activity that goes against the law is just one step. Public and private overseers need to insist that mutual funds must publish quarterly statements that clearly show how much investors are paying in the form of fees on their accounts. Investors need to know how much the mutual-fund managers are actually compensated. And they need the SEC to withdraw its 12(b)-1 rule, which it imposed on investors in 1980 to help bolster the mutual-fund industry. Mutual-fund reform must take its place beside corporate reform if America is ever to restore popular trust in investing again. With the economy reaching lift-off and the stock market moving higher once again, there is no time to waste.

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—Dean Athanasia, Executive VP, Fleet National Bank

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3 September 29

Grow/Trim Companies

THE TOP 25

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BusinessWeek

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THE
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ESLEY
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PROS,
CONS,
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AIMLER
HRYSLER
THE MERGER
MISTAKE?

VESTING
OULD YOU
Y TIMING
E MARKET?

FEEES! FEEES! FEEES!

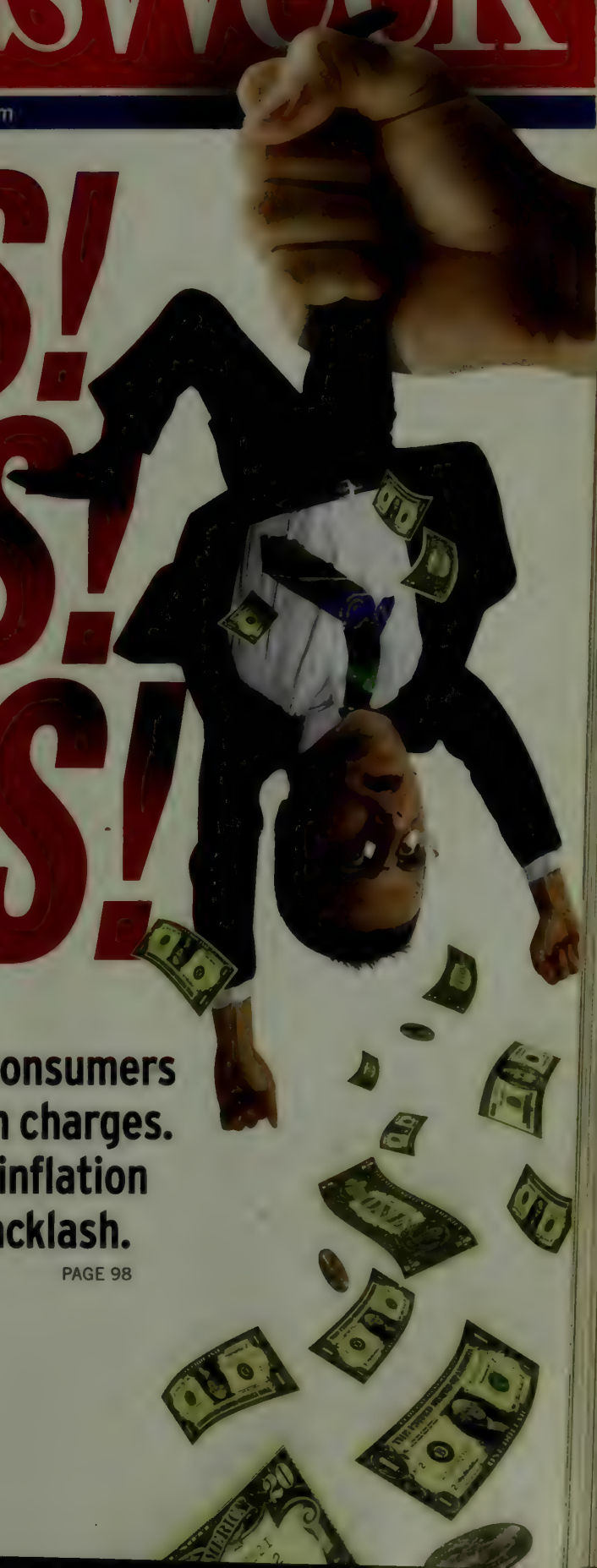
Unable to raise prices,
companies are hitting consumers
with hundreds of hidden charges.
That's creating stealth inflation
and fueling a popular backlash.

PAGE 98

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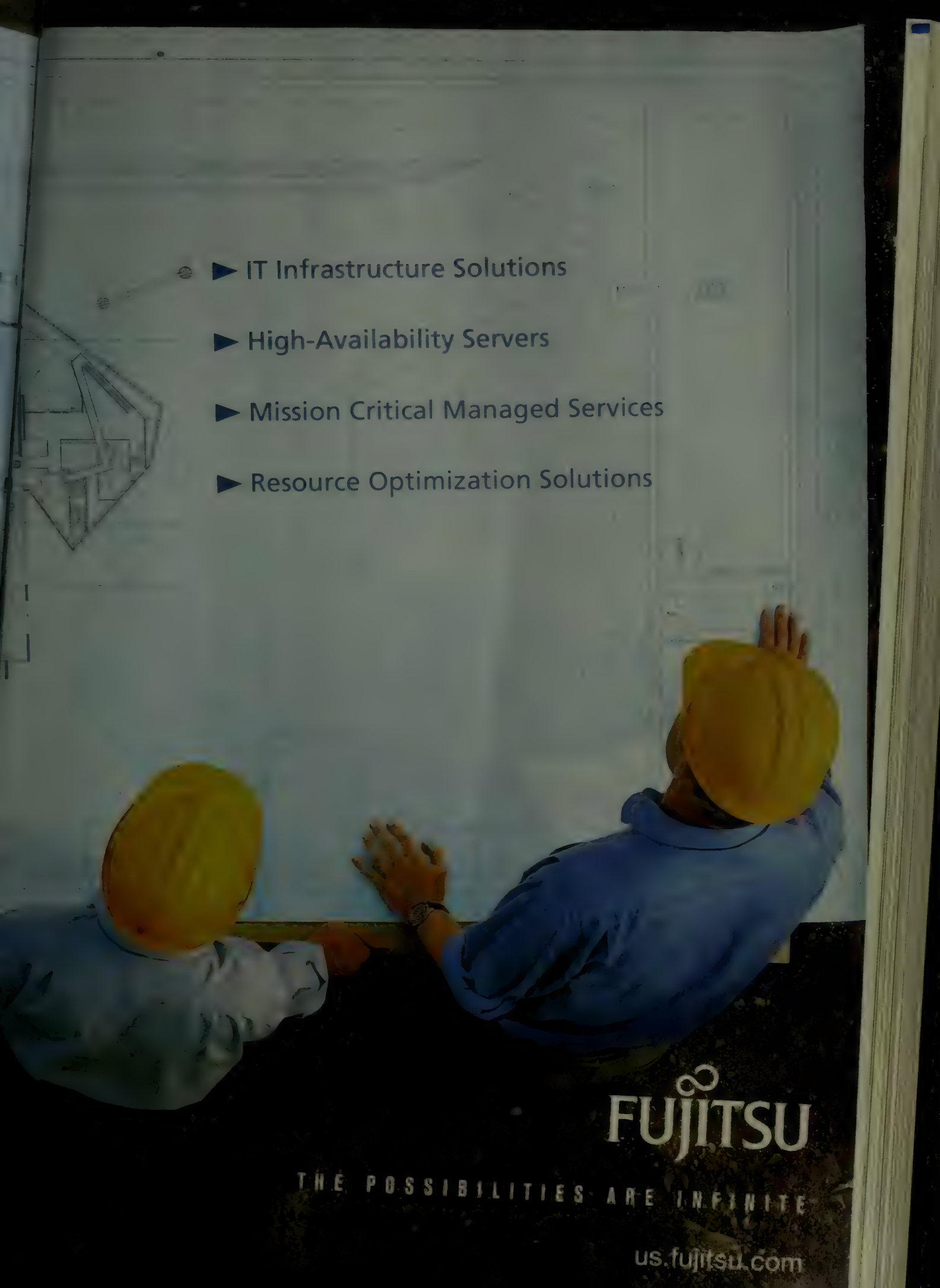
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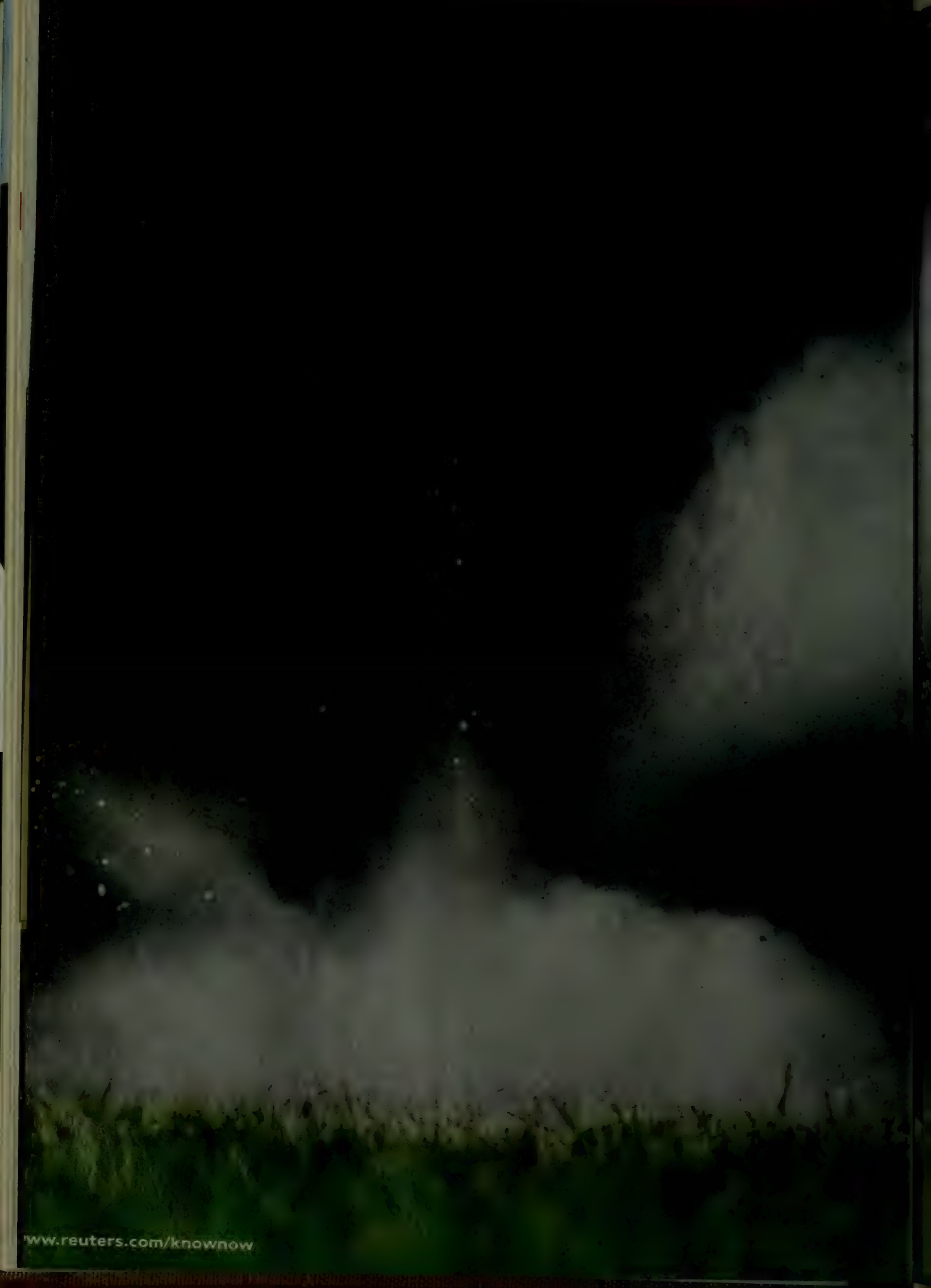
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or just turn out the lights and go home?

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COVER STORY

FEES, FEES, AND MORE FEES

Home of the brave,
land of the fee:
Americans are being
nickel-and-dimed to
death on the sly. Now
they're balking page 98



BusinessWeek

SEPTEMBER 29, 2003

Cover Story

98 FEES, FEES, AND MORE FEES

In an economic climate that has stunted companies' pricing power, an insidious alternative has taken root: stealth fees—on everything from cell phones to hotel rooms to overnight package deliveries. And they're adding up to big bucks. In fact, the impact on consumers flies in the face of official statistics on inflation. But Corporate America has pushed the model of raising prices through surreptitious fees so far that consumers are starting to band together to resist

104 COMMENTARY: FIGHTING FEES

The new stealth fees may seem unavoidable. In fact, there are ways to fight back

News: Analysis & Commentary

36 BIG CHANGES AT THE BIG BOARD

With Dick Grasso gone, the New York Stock Exchange is likely to get an overhaul

39 WESLEY CLARK: BATTLE-READY?

The Arkansas Democrat and former general is politically untested

40 AN EX-GENERAL SIZES UP IRAQ

In *Winning Modern Wars*, Clark's view clashes sharply with Bush's

42 FINALLY, A REAL RECOVERY

The global economy is picking up steam, thanks to stronger demand in the U.S., China, and Japan

46 COMMENTARY: DETROIT

A tentative contract with the UAW will allow the Big Three to trim workers and boost productivity

48 MICROSOFT'S KILLER APP

With the giant entering the antivirus market, the established players are biting their nails

50 IN BUSINESS THIS WEEK

International Business

54 AUTOS: DAIMLERCHRYSLER

Was the massive merger a colossal mistake? Many investors want to unravel the deal—and are calling for the head of Jürgen Schrempf

58 MALAYSIA: AFTER MAHATHIR

A new economic model is needed. Can Abdullah Badawi provide a path for growth?

63 SWEDEN: THE EURO

By saying no to the euro, it has changed the path of EU integration

64 INTERNATIONAL OUTLOOK

Now, Iraq is giving both An and Washington strong motivation to improve their strained relations

Economic Analysis

30 ECONOMIC VIEWPOINT

Barro: The stubborn jobless puzzle is puzzling but far from scary

33 BUSINESS OUTLOOK

U.S.: A reprieve for manufacturers
South Korea: Hope in exports

Government

53 WASHINGTON OUTLOOK

Medicare reform: As reality sets in, a new, stripped-down drug benefit plan emerges

Sports Business

66 COMMENTARY: BASEBALL

The playing field is getting ever less level

The Corporation

68 SEEKING THE SWEET SPOT

Hershey is under pressure to satisfy Wall Street's craving for earnings growth



T AT NYSE
so's out, big
ges are in page 36



- ▶ Should you time the market? page 134
- ▶ Closed-end funds: picks and pans page 138
- ▶ Attention, cheese fanciers page 140
- ▶ Dividends for inflation fears page 144



STALLED
DaimlerChrysler's
vexed merger page 54



EARS OF THE E-ECONOMY
ty-five visionaries who hung in there
made e-commerce credible again page 116

TOO SWEET?
Hershey is taking a
licking from
bigger food
giants in
the snack
market
page 68



FORWARD MARCH
The early skirmishes
facing General Clark
page 39

Science & Technology

MAKING OUT STROKES
Concentric is testing a corkscrew
to break up blood clots in arteries

DEVELOPMENTS TO WATCH
Sleeping-eye CD players; germs to
eat natural gas; robots in the ruins

Marketing

COMMENTARY: DO-NOT-CALL
No doesn't mean no: Loopholes
mean the phones will keep ringing

BERCROMBIE'S FADING CACHET
Post-conscious teens are shunning
the pricey brand

Management

COMMENTARY: EMPLOYEES
Companies will have to hustle to
keep workers from jumping ship

Legal Affairs

THE WAR ON PIRACY
How the music industry charted its
campaign against Web pirates

MUSIC'S DOUBLE BACKLASH
Peer-to-peer companies are joining
together for a counterattack

Finance

- 106 STATES VS. THE SEC: A TRUCE**
Will their recent cooperation in
policing money pros last?
- 107 VENTURE CAPITAL'S DILEMMA**
With \$84 billion to invest, VCs
remain averse to unproven startups
- 110 COMMENTARY: ORBITZ**
This IPO doesn't deserve to fly

Special Report

- 116 E-BIZ: THE TOP 25 PLAYERS**
Who's behind the amazing
turnaround in the Net's fortunes

The Workplace

- 112 STORMING YALE'S IVY TOWERS**
Why the university's labor relations
are such a mess

BusinessWeek Investor

- 133 DIVIDENDS**
A Canon camera; retirement; hotel
survey; China currency play

BusinessWeek online

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134 SHOULD YOU TIME THE MARKET?

It all depends whether you believe
that, long-run, stocks revert to a
mean or take a "random walk"

138 CLOSED-END FUNDS: TOO LATE?

With their reliance on bonds, the
heyday for these funds may be past

140 NEW WAYS TO SAY CHEESE

Sample the bounty of handmade,
locally produced varieties

142 FIGURES AT YOUR FINGERTIPS

All kinds of federal info is just a
mouse click away

144 THE BARKER PORTFOLIO

A basket of dividend-paying stocks
to ease inflation anxiety

146 INSIDE WALL STREET

Features

- 12 UP FRONT**
- 16 READERS REPORT**
- 18 CORRECTIONS & CLARIFICATIONS**
- 22 BOOKS**
Krugman: *The Great Unraveling*
- 24 WILDSTROM: TECHNOLOGY & YOU**
The Treo 600 is one smart phone
that's actually easy to use
- 148 FIGURES OF THE WEEK**
- 150 INDEX TO COMPANIES**
- 152 EDITORIALS**

28243	21229	52244	87123	44188	91606	07106	80212	80274	83302	77054	11040	48180	91785	06108	44113	77031	7730
78159	01849	48243	73110	14231	91791	80041	29411	85109	55343	22704	76208	30295	07630	08846	20816	57332	7610
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27410	85227	94137	11211	92551	80014	80314	48401	22008	06533	58134	05154	25713	80290	19033	85716	92859	9241
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06033	38116	75320	32229	44398	10002	12206	10168	80441	84056	94487	44128	01855	98146	10879	39157	1010	
83728	72221	78559	44114	43603	02211	79424	82209	20013	19604	37400	85700	76082	84089	95135	19066	88331	6000
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06511	80322	80682	11378	06913	35898	54136	84106	73179	35615	78778	07882	44194	70882	98112	20192	83303	3000

The merger with Airborne has made DHL stronger in these areas:

80251	14580	46223	94519	15203	84037	02919	23704	77429	10467	70629	77237	98027	34667	40808	88422	80701	20910
28410	10032	84135	46225	80544	91946	32609	07650	46741	25726	46748	68509	92155	46274	28230	12288	23485	23485
02118	55124	33624	19188	73130	29260	19187	78768	22227	80634	49516	17121	43604	63110	97216	29404	83021	95626
46743	48554	20390	43212	91735	10090	20124	95164	44177	91201	55103	75060	54302	46227	91108	18033	80007	31130
11223	99210	34243	92403	23504	37916	91729	07458	78552	66223	33714	85254	20587	93701	14804	19538	01854	44094
15120	60107	11358	43218	37311	60702	93150	23666	17364	92335	85722	10069	55111	35805	02284	15283	93063	93063
32793	00705	64125	20077	44136	75390	64123	80150	46253	02140	07109	80280	15264	48157	70507	34233	67227	10464
77053	45052	30126	37716	30305	03063	90261	13224	46404	37620	32828	33913	91773	33110	61636	11771	84122	34205
45274	32641	01760	19191	64113	92145	21162	33420	07734	49024	20375	91121	95120	15253	02468	84115	53789	38110
33603	82683	43228	20018	73105	90708	07961	38112	53793	01144	78240	44308	93094	97208	74119	80247	06073	91711
73147	60074	20042	91505	84042	78212	35810	33403	80603	28801	60160	08109	46613	80022	14612	74141	11354	94022
30005	25392	30358	29208	60617	21215	20742	01040	33428	02239	31488	19128	74117	79913	32211	88113	20881	67001
93007	48182	48179	08059	43600	11545	80309	44106	11758	63199	70087	07533	60171	20532	07306	20902	83680	90853
50522	92420	11750	48311	22230	98430	51510	77040	92194	94588	07752	92805	49003	03873	19147	43835	54603	43218
30238	49356	19104	80306	90805	12179	32570	63177	85718	10155	01810	49361	27420	21062	80112	11416	30088	49530
02043	48375	11432	00645	60618	33093	78712	94154	19484	20091	94080	88520	37245	28224	99228	08989	93110	84108
60077	70131	07080	48922	19405	68522	11423	90201	11359	35759	35223	85704	15266	20223	19495	88845	97740	24030
35210	02482	46322	94915	07477	20307	44120	90059	32401	45223	91797	00623	22037	92815	40250	22201	32837	70816
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15015	14615	14660	20904	40210	78475	55401	10260	11516	11598	50076	11550	48038	94134	19183	60091	11568	45419
20193	83642	14120	33445	54301	88105	19181	45479	48107	07108	18505	01129	55436	64190	94930	43265	20099	30301
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06062	92023	17504	85073	87120	07524	11101	07045	80310	94521	45342	92021	48220	28791	17057	98054	90306	77077
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90503	94009	94102	07508	97008	11743	84133	85285	95124	37424	07097	12233	19355	61130	05032	98171	19046	08117
48663	53408	02048	33010	76112	77011	01745	20814	75227	28262	82781	01905	15220	19499	92711	70125	88294	73112
42681	90411	20534	84798	43617	53210	29306	60526	32715	01020	06582	73160	46798	48842	95108	06857	15213	20242
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DHL is now a major force in every zip code in America.

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92136	73184	00426	20219	90036	90278	30318	19426	64130	23284	01748	80740	77050	00002	28253	01133	10459	01580
24031	21235	68234	06005	55116	90002	64136	45433	70170	11366	07719	20886	00206	92401	93101	18705	80249	84148
53777	70550	03002	73048	70000	00000	80274	94302	21224	01532	20027	95352	33556	76007	38108	94622	67001	91401
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37234	83711	12309	33003	85747	64147	85201	73148	31197	79902	53701	19612	98023	22320	91722	20002	44000	44000
46240	18003	06430	84415	91615	29250	35222	21055	29229	92101	19070	07495	90001	33239	00054	45208	32812	30156
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75224	25400	00001	97221	10004	22301	92135	33234	82000	61264	30322	28105	75061	54912	19465	02000	23325	73107
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00374	23005	70000	15046	38101	94107	31150	35220	01940	90732	33155	85704	10550	84074	10976	29304	75354	40555
00399	53267	77379	60510	60000	50327	64108	07309	07762	84105	92124	20037	08875	07703	07021	90047	20216	71118
02903	07740	15272	49418	01944	22216	43215	06880	78553	20894	91009	20000	20211	46291	80058	20011	46258	67256
24015	32317	78782	35229	70520	94001	97258	68176	00078	55102	94481	84003	10285	48552	48325	10113	95056	11003
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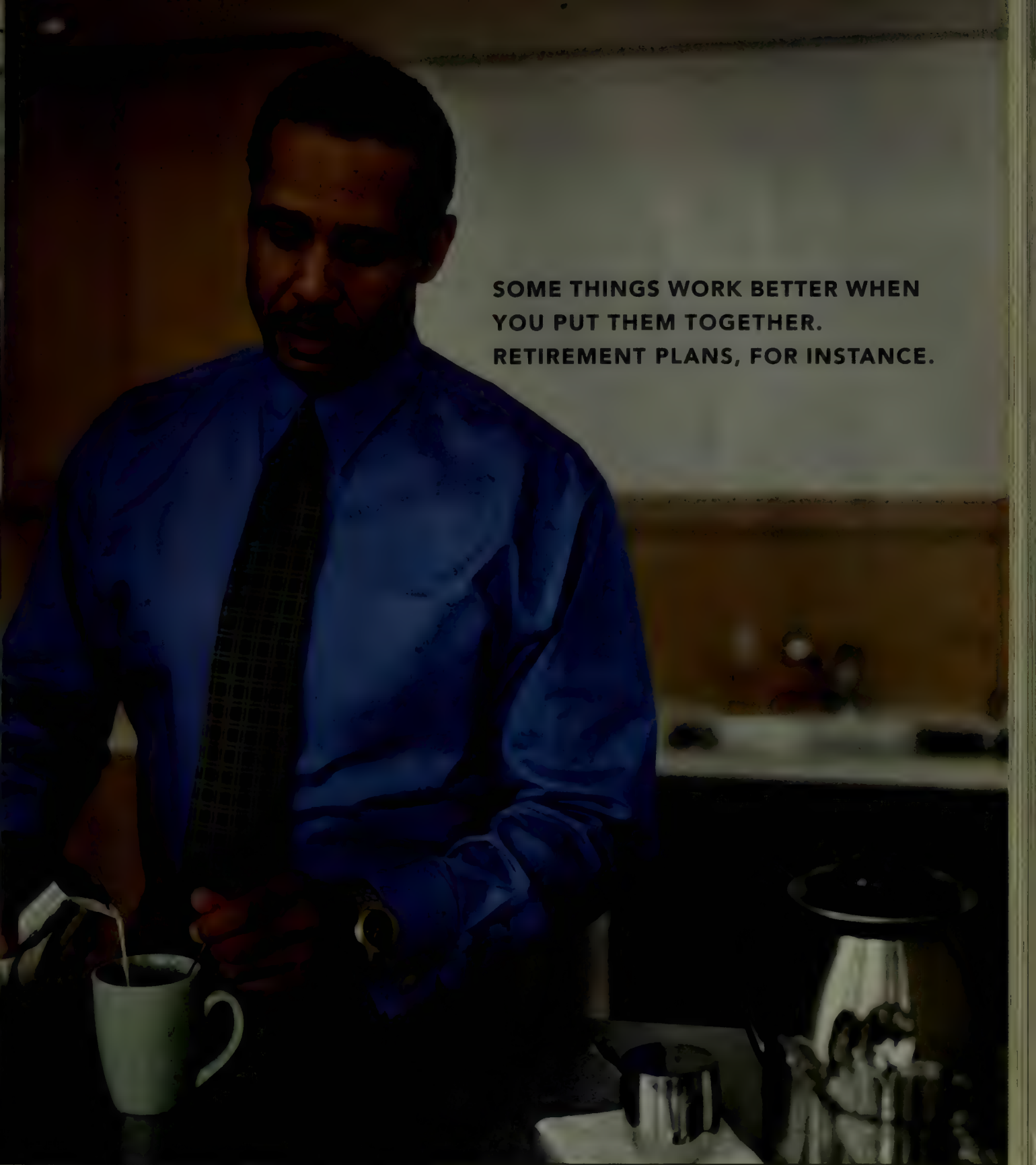
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TAX DOLLARS AT WORK

CALLING NEW JERSEY VIA NEW DELHI

IT'S NOT JUST CORPORATE America that's shipping jobs overseas. Faced with the need to slash spending and modernize computer systems, state agencies from New Jersey to New Mexico are funneling programming and call-center work to contractors that use overseas labor. Of the \$3.8 billion in tech spending states will outsource this year, nearly 5% will go offshore, says Gartner Dataquest analyst Rishi Sood. That will double by 2006.

To halt the flow of public jobs overseas, at least six

states are considering legislation to stop the use of foreign labor. "State governments should not be exporting jobs when we have skyrocketing unemployment," says Shirley Turner, a Democratic state senator in New Jersey. Lawmakers say outsourcing also erodes states' tax bases.

**HELP
LINE:** In
India

Still, offshore workers are a bargain, and they're able to work with states' aging mainframe computers, says Martin Clague, CEO of consulting firm Covansys. "Mainframe skills have been atrophying in the U.S.," he says. Covansys has 40% of its 4,800 workers in India.

State officials say that they are simply providing taxpayers with services at the lowest cost. "Unless the laws are changed to restrict it, you're going to see more of this," says Allen Larson, South Carolina's unemployment insurance director. If so, even more U.S. jobs will flow overseas. *Dean Foust*

TALK SHOW "You make a lot of money off the piracy [of music], don't you?"

—Appeals Court Judge John Roberts to a lawyer for Verizon, which is challenging subpoenas to divulge customers' names

HAULS OF IVY

ABOUT THAT B-SCHOOL...

WITH THE DOWNTURN PINCHING college budgets, one New Jersey school is getting unusually proactive about bringing in the cash. On Sept. 16, William Paterson University sued E*Trade Financial, claiming the firm reneged on a \$5 million pledge.

Former E*Trade CEO and Paterson alum Christos Cotsakos pledged a \$10 million gift in 2001—\$5 million from his personal piggy bank and \$5 million from E*Trade's coffers. The school named its business school after Cotsakos and built the E*Trade Financial Learning Center,

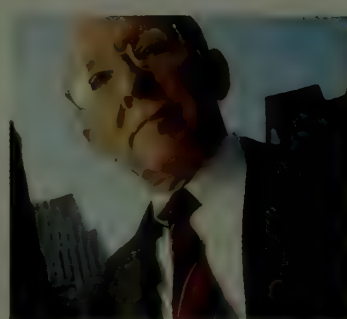
with a simulated trading floor. Another condition: The school was to hold the money in an E*Trade account.

But the school only received half of E*Trade's gift and was told in May that there would be no more money coming, the suit says. Paterson University's lawyer, John Rowe, the school's lawyer, says Cotsakos has not paid his full \$5 million yet. E*Trade and the school declined comment. Attempts to reach Cotsakos were unsuccessful.



COTSAKOS:
I owe U.

Cotsakos left E*Trade in January after a flap over a \$77 million pay package. He still holds 3.9 million shares worth almost \$40 million. That's worth a few more schools. *Brian Hind*



YORK:
Bad
timing

son, paid \$725 million to take Micro Warehouse private.

But this past Sept. 11, Micro Warehouse filed for bankruptcy protection—just three days after York unloaded most of its shares to rival CDW for a paltry \$2 million. What went wrong? The leveraged buyout left Micro Warehouse with a crushing debt—more than \$100 million at the time of bankruptcy. "They loaded the company with debt just in time for the worst cycle in the history of the industry," says Roy Vallee, CEO of electronics distributor Avnet.

Also left holding the bag were unsecured creditors, including Ingram Micro, \$17.9 million; Hewlett-Packard, \$8.6 million; and Toshiba, \$3.1 million. Distributor Ingram says it's considering legal action because Micro Warehouse did not divulge its problems in negotiations. Micro Warehouse didn't pay York's former employer either. It owes IBM \$2 million. York declined to comment. *Spencer E. Ante*

AFTERLIVES

JEROME YORK'S WAREHOUSE OF WOE

THE TECH WRECK HUMBLed its share of twentysomething execs, but it has wreaked havoc on seasoned hands, too. The latest victim: Jerome B. York, the former chief financial officer of Chrysler and IBM, who cut billions of dollars in costs to help turn around those corporate icons.

In February, 2000, York, along with the Los Angeles buyout firm Freeman, Spogli, and a group of private investors including Michael Ovitz and former Northwest Airlines Chairman Gary Wil-

THE LIST CRIME WATCH

Merrill Lynch's recent \$45 million fraud is among the largest at a U.S. financial institution. Below, the biggest U.S. embezzlement cases:

FINANCIAL INSTITUTION	AMOUNT	SCHEME
EVERGREEN INTE. 2001	\$105 million	Founder Andrei Koudachev indicted on charges of fraud and money laundering
MERRILL LYNCH 2003	\$45 million	Former energy trader Daniel Gordon is being investigated for a questionable hedge contract
OAKWOOD DEPOSIT 2002	\$40 million	CEO Mark Steven Miller kept two sets of books and funneled funds into his own accounts
SHEARSON LEHMAN 1987	\$19 million	Broker Mark Stahl used check kiting to steal \$19 million



Data: Fitch Risk

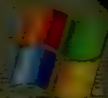
Build a 200-server infrastructure.

With 10 servers.

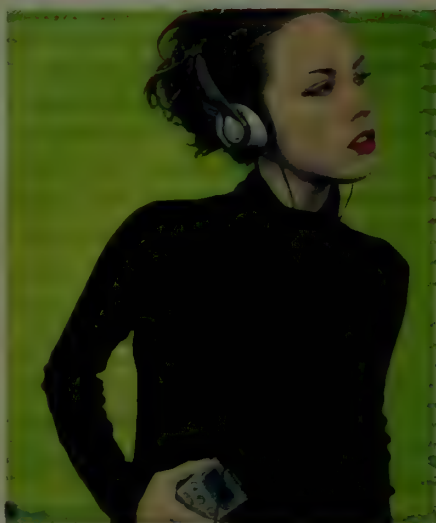
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Up Front



DOWNLOAD DEBATE

YOU BOUGHT A SONG. NOW TRY TO SELL IT

IN CONTRAST TO THE RECORDING industry's litigious stance on downloading music, Apple Computer promotes its iTunes Music Store as free from legal hassles. "It's your music," declares its Web site.

If so, you should be able to give it away or sell it, right? A section of copyright law called first sale gives the owner such rights. Busi-

nesses—from used bookstores to Blockbuster—exist because of it.

But consider the experience of George Hotelling. He wanted to sell a song he bought on iTunes for 99¢ to test the law. On Sept. 3, he put the song on eBay, but the auction was canceled. EBay doesn't allow the resale of digital products delivered online. Besides, Apple's anti-piracy software prevented Hotelling from transferring ownership. So he had to give his account to a friend, who paid 50¢ for the song. "You have less control than over a physical CD," Hotelling says. Apple declined to comment.

As customers buy more digital works, resale rights will become a bigger issue. "If [Apple] prevented him from selling, then it wasn't right to say he owned a copy," says Jessica Litman, a Wayne State University law professor. Then what did Hotelling pay for? *Heather Green*

I-WAY PATROL

MORE WAYS TO PRICE-SHOP ONLINE

LEFT FOR DEAD IN THE dot-com crash, Web sites that compare prices are staging a surprise comeback. Traffic to Dealtime, BizRate, and PriceGrabber.com has surged up to 133% from a year ago, according to market researcher Nielsen/NetRatings. "It feels like 1999, but with real results," says Nirav Tolia, chief operating officer at Dealtime.

Credit more savvy consumers—and retailers, who know that shoppers directed their way through price-com-

parison sites are primed to buy. The fees that retailers pay for these leads have made each company profitable. Now, the comparison sites are gearing up for the holidays by adding new items such as home products. And later this month, Dealtime will be relaunched as Shopping.com, a name that's easier to recall.

Yet their success may be short-lived. Google, Yahoo!, and others are building their own comparison services. "Portals and search engines could siphon off this traffic," warns Forrester Research analyst Carrie Johnson. The result: Only one independent is likely to survive. Darwin, it seems, still rules the Net. *Robert D. Hof*

DRAWN & QUARTERED



BOOK NOTES

OF-TOLD TALES

JUST HOW MANY BOOKS ON the AOL Time Warner merger do we really need? Three will be out by January, when HarperCollins offers *Fools Rush In*, following publication of *Stealing Time* (Simon & Schuster) and *There Must Be a Pony In Here Somewhere* (Crown). By late fall, there will be six journalistic chronicles on Enron and two new portraits of Oracle's Larry Ellison—to add to four earlier ones.

Editors' headline-chasing—helped by some sorry developments in the business-book biz—is largely to blame. Since 2000, sales have dropped by 9%, to \$834 million in 2002. That's due in part to cutbacks in corpo-

rate-training program which buy management a self-help books. And the economy's woes dampen enthusiasm for personal finance. That leaves business narratives as a primary focus for publishers.

Does it make sense to release so many similar books at the same time? "If book buyers have to pick from among five books, they're probably not going to pick anything," says Simon & Schuster editor Fred Hills. It sounds like yet another case of fools rushing in.

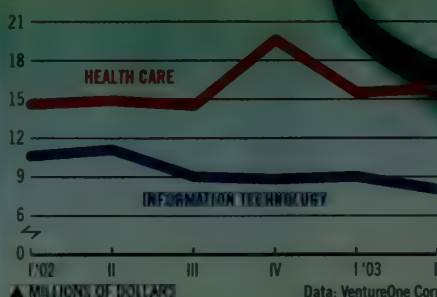
Hardy Green



THE BIG PICTURE

A HEALTH-CARE BUBBLE?

Venture capitalists are valuing young health-care companies almost twice as richly as technology startups. Below, the average worth assigned by VCs to companies just before making an investment:



Polls, surveys, and other items for consideration in this section should be sent to upfront@businessweek.com

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Cape Town
Barcelona
Sydney
London
Moscow
Belize
Buenos Aires
Venice
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South Beach
Waikiki Beach
Beijing
Grand Cayman
Zurich
Istanbul
Lima
Tokyo
Singapore
Sapporo
Auckland
Bermuda
Aruba
Glasgow
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CAN WE MAKE COMPUTERS SAFE?

Homogeneous computer networks, like homogeneous populations of plants and animals, are at a higher risk of infection than heterogeneous networks ("Epidemic," Cover Story, Sept. 8). Unfortunately for many businesses, their corporate networks were built nearly exclusively from Intel Corp.-based PCs and servers running variants of the Windows operating system. This produces an environment receptive to infection and to the nefarious programmers who write "viruses."

Obviously, a network running multiple operating systems upon multiple hardware architectures would not be immune to infection. However, the effects would be mitigated. Cyberdiversity, like biodiversity, produces a more resilient distributed system. It is also one part of a possible total solution that can be implemented immediately. Most businesses probably cannot replace their Windows-over-Intel network, but they can diversify.

Gregory L. Opp
Hudson, Mass.

While spam and e-mail viruses have mostly been a nuisance so far, the potential threat is far more sinister. The next major terrorist act may not be bombs or planes flying into skyscrapers but cyberhacking into the nation's businesses to access funds and information. So much of our nation's business is conducted on the Internet, with relatively little protection against fanatically committed international criminals with the motive and incentive to rob

our banks, raid our investments, and divert money from all manner of retirement funds and other accounts.

With all the Administration's rhetoric about homeland security, I don't hear many ideas in regards to protecting our financial resources from this kind of threat.

Linda Umsted
Mililani, Hawaii

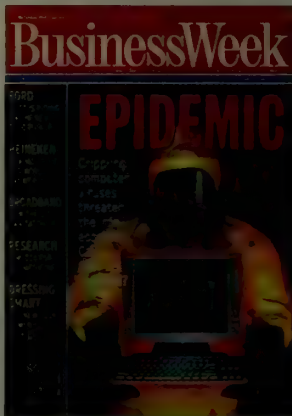
Your writers failed to emphasize the most important party responsible for the failures of Microsoft Corp. and other

companies to provide adequate security in the products they market: the customer. How many businesses or individuals include security in the selection criteria for computer and network hardware and software? How many companies have full competent security staff that report to executives with sufficient authority to control the security architecture and administration of their networks? Why should Microsoft or any other vendor attempt to deliver what the market does not ask for or buy?

In that regard, the market for computer-network security is similar to the market for auto-safety devices and design. It will require federal legislation for needed computer and network accountability and security controls. The technology to make computers and networks more secure exists, but few are willing to pay for it.

Dayle Collins
Warsaw, Va.

Remember, without a "host," a virus cannot reproduce and spread. An analog



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CORRECTIONS & CLARIFICATIONS

In "Look before you listen" (BusinessWeek Investor, Nov. 25, 2002), *BusinessWeek* incorrectly stated that Jay D. Kaiser paid \$8,150 in fines to the state of Washington for acting as a financial adviser when he was not registered as such. Kaiser's payment of \$8,150 represented reimbursement of the costs of investigation, registration, and late-renewal fees. Although a fine of \$10,000 was imposed on Kaiser, the fine was suspended.

In "The eBay economy" ("The future of technology," Cover Story, Aug. 18-25), a reference to eBay Inc. selling more automobiles than AutoNation is incorrect. As noted later in the story, eBay sold more used cars than AutoNation.

In "Outsourcing war" (Special Report, Sept. 15), a reference to President Dwight D. Eisenhower's farewell address to the nation, in which he coined the term "military-industrial complex," incorrectly referred to Eisenhower as a retired four-star general. He was a five-star general.

In "A hothouse for biotech" (Science & Technology, Sept. 8), Marvin Cassman is misidentified as an alumnus of the University of California at San Francisco. His PhD is from the Albert Einstein College of Medicine in New York.

"Ready to say 'help wanted'" (News: Analysis & Commentary, Sept. 22) should have specified that CDW Corp. plans to lift hiring in its sales force by 11% to 1,470 in the second half of 2003.

gy in the physical world would be if carmakers put a button on the outside of every vehicle that was not marked but if pressed would prevent the vehicle from starting until another button in the engine compartment was pushed. If these buttons existed, petty pranksters would run around mall parking lots and press them every day, just to be a nuisance. Of course, the federal government would step in and require the auto makers to remove the buttons. Microsoft has buttons in the form of security holes all over its software, and the virus makers just press the "buttons."

Steve Kohler
Suwanee, Ga.

Your story states that Linux and Mac OS X are not inherently more secure than Windows. But they are, indeed—because they have not been designed

to maximize convenience at the expense of security. My last security breach on a Linux box was around 1998, and I'm not particularly aggressive about applying patches.

Trying to secure Windows is an almost daily battle. The fact that Linux costs a lot less is just icing on the cake.

Robert Weiler
Mill Valley, Calif.

A DO-NOT-E-MAIL REGISTRY WOULD ONLY HELP SPAMMERS

"Viruses and spam: Time to fight back" (Editorials, Sept. 8) was off base in calling the battle against spam "the easy part." A do-not-e-mail registry is not the magic solution to the spam problem—and marketers aren't the only ones who are saying this. While your editorial calls on the Federal Trade Commission to create such a registry, the FTC is in fact on record as one of the staunchest opponents of the concept. This is because spammers, who already violate many existing laws, show no signs that they would suddenly comply with a do-not-spam list.

Taming the onslaught will require a multipronged approach, including tough

new laws, stepped-up law enforcement, anti-spam technology, and tough industry self-regulation.

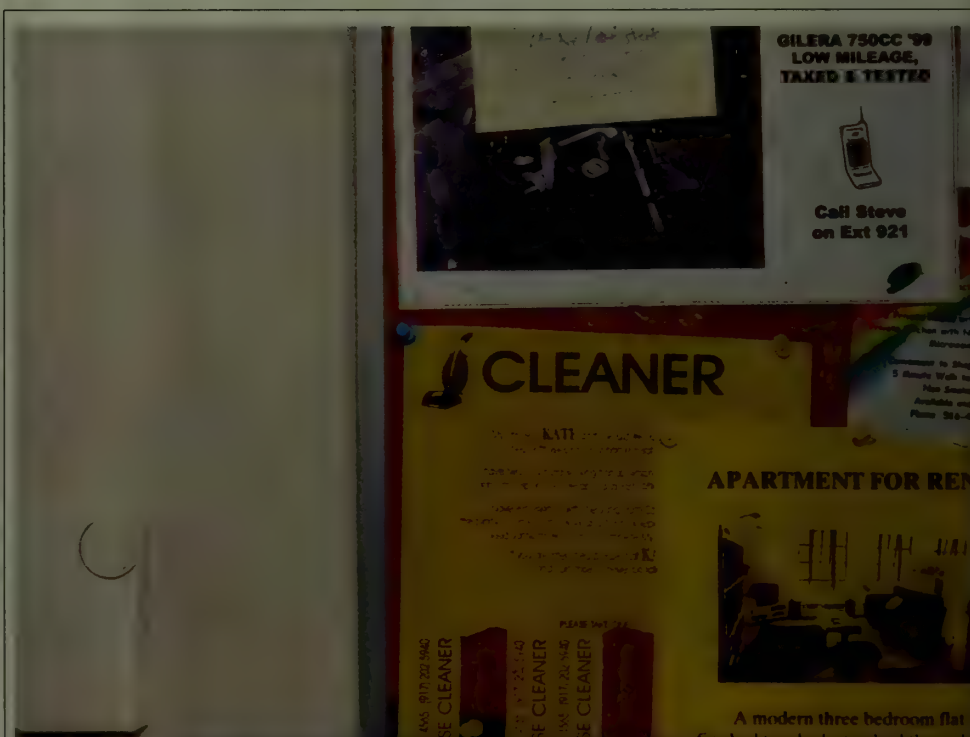
H. Robert Wientze
President & CEO
Direct Marketing Ass'n
New York

"Viruses and spam: Time to fight back" suggests that Washington replicate its popular donotcall.gov registry with a donotspam.gov site, allowing consumers to receive e-mail only from chosen retailers and marketers. This shows a lack of understanding of how spam works. This idea would be extremely popular with spammers, since it gives them the opportunity to harvest e-mail addresses from this site and spam them from outside U.S. jurisdiction.

Ralph Birnbaum
Modi'in, Israel

WHAT IF MUSIC DOWNLOADERS DECIDE TO REALLY REBEL?

These technophobic oligopolists, as you call them, will undoubtedly win the legal battle ("Music pirates, you're sunk," News: Analysis & Commentary, Sept. 8). But then, their enraged cus-



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Neal M. Grolnic
Driftwood, Tex.

Converting from a traditional defined-benefit plan to a cash-balance plan has a lot to do with "raiding" plan assets. First of all, there is no "tax penal-

Changing the status of a group of employees to independent contractors is an Internal Revenue Service matter. If it happens, the employees keep any benefits accrued; no "looting" of pension assets results.

Susan J. Lacey
Coral Gables, Fla.

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INTRODUCE
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TO WAIT FOR THE
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To succeed today, your enterprise has to undergo a rapid transformation from a series of functionally driven silos connected by a common mailroom to a whole whose sum is greater, and more profitable, than its parts.

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Of course, the concept of integration is one thing. Accomplishing it is quite another.

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THE GREAT UNRAVELING
Losing Our Way in the New Century
 By Paul Krugman
 Norton • 426pp • \$25.95

AN ECONOMIST'S CALL TO ARMS

It has been a dozen years since he won the coveted John Bates Clark medal, awarded to the best American economist under age 40, but Paul Krugman remains something of an *enfant terrible* among economists. Krugman teaches at Princeton University and, since 2000, has written a twice-weekly column for *The New York Times*. He has done and continues to do first-rate theoretical work in such areas as international trade, exchange rates, and economic geography. At the same time, he has cast an increasingly critical eye on current economic issues and the failings of policymakers and pundits via a number of popular articles and books.

The Great Unraveling, Krugman's new book, made up largely of *Times* pieces but with a key introduction and comments, is his most provocative and compelling effort yet. In his incarnation as a *Times* contributor, the author has acquired something that his earlier works lacked: an impassioned moral and professional indignation aroused by what he terms "the outrageous dishonesty" of the Bush Administration's policy pronouncements.

While Krugman counts himself as a moderate liberal, his writings in the 1990s often faulted the economic reasoning of both Democrats and Republicans. His recent, almost obsessional anti-Bush stance, he writes, evolved as he began to observe a persistent deceitfulness in Administration claims. In the reprinted columns, he punctures the misleading rationales advanced for such initiatives as Bush's Social Security plan, tax cuts, and energy and environmental policies. Indeed, the book's unifying thesis is that the Administration's deliberate obfuscations reflect a hidden agenda to radically transform the nation's economic and political institutions.

How else, asks Krugman, to explain the Administration's flagrant fiscal irresponsibility? Bush's original \$2.5 trillion,

10-year tax cuts, for example, were justified partly with the contention that they would easily be paid for out of huge projected budget surpluses. Yet when those surpluses morphed into soaring deficits (\$550 billion next year alone), the Administration saw no reason to shift gears. Instead, it has pushed for more cuts and legislation to make many of its original cuts permanent—even though they mainly benefit very wealthy households and don't even kick in till later in the decade. And this in the face of the pending retirement of baby boomers, which will soon put massive pressure on federal pension and Medicare outlays.

Similarly, Krugman points out that the Bush plan to "solve" Social Security's problems by diverting a share of payroll taxes into individual accounts simply ignores the fact that these funds are earmarked for the pensions of soon-to-retire older workers whose own taxes paid for the benefits of previous generations. As Krugman's lucid exposition of the complexities of Social Security financing makes clear, this would weaken the system's financing, forcing painful benefit cuts unless future taxpayers agree to pick up the tab.

Like some of Bush's Democratic critics, Krugman sees the same duplicity at work in the foreign policy arena. Many will agree with the Administration's current contention that the invasion of Iraq was justified because it ended a barbaric regime that brutalized its citizens. But the fact remains that the war was sold to the public on the grounds of Saddam Hussein's alleged ties to al Qaeda and his possession of weapons of mass destruction that posed an imminent threat to U.S. security. These claims still remain unsubstantiated by hard evidence.

Critics on the right tend to dismiss Krugman as a shrill left-wing scold. In fact, he is a distinguished mainstream economist, and as his book attests, holds opinions on the benefits of free markets, trade, and globalization that would enrage supporters of Ralph Nader. Defending the World Trade Organization, for example, he writes that in "this past century, every case of a poor nation that worked its way up to a more or less decent, or at least dramatically better, standard of living has taken place via globalization."

Interestingly, a positive, almost glowing assessment of the Bush President, authored earlier this year by Bill Keller, Krugman's colleague at the *Times* and now its executive editor, concluded that Bush indeed intends to steer the nation in precisely the radically conservative directions Krugman describes. These include sharply reducing or eliminating the progressivity of the tax system (in part by ending the taxation of capital income) and gradually downsizing Social Security and other safety nets, accelerating the deregulation of markets, freeing up the exploitation of resources, and privatizing government functions. Keller reported that conservative strategists who share most of these goals, such as Grover Norquist of Americans for Tax Reform, are gleeful because they believe Bush possesses both the boldness and the po-

litical smarts to induce voters to accept his program.

In contrast, Krugman, who regards his book as a wake-up call to the electorate, believes the public is mostly centrist in its views. He is convinced that few Americans, if they fully understood Bush's radical agenda, would choose to jettison cherished institutions and go it alone in today's highly uncertain economic environment.

Some will dispute this judgment. But who can deny that transparency and truthful information about a government's policies and goals are as essential to the successful functioning of a political democracy as they are to that of a free-market economy?

BY GENE KORETZ

Contributing Editor Koretz has watched both the economy and economists for more than 30 years.



KRUGMAN DETAILS "OUTRAGEOUS DISHONESTY" IN THE BUSH CAMP'S RADICAL AGENDA

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The strength to cover the world's largest business and financial risks.

BY STEPHEN H. WILDSTROM

tech&you@businessweek.com

THIS SMART PHONE IS ACTUALLY EASY TO USE



Surprise! You can actually operate the Treo 600 with just one hand as you would a phone

Smart phones require a lot of compromises. These devices, which combine the functions of a voice phone, a PDA, and a wireless data device, have been too big to be the perfect phone and too cramped to be ideal for e-mail or Web browsing. But the Handspring Treo 600, available from Sprint PCS in October (and later from Orange in Europe) improves the trade-offs dramatically.

Until now, the Treo 300, introduced last year, was the best of the breed. The Treo 600, armed with a bright color display, a fast processor, and the latest operating software from PalmSource, leaves it in the dust. The 600, which eliminates the 300's flip-phone cover, is about the same length (4½ in. plus antenna) and thickness (1 in.) as its predecessor. But it is a vital half-inch narrower, meaning it fits comfortably even in relatively small hands. At first glance, the tiny keyboard looks too small to use, but I found it the equal of the bigger versions on the 300 and Research in Motion's BlackBerry.

I think, however, that the secret of the new Treo's usability is something more subtle. We expect to use a phone one-handed, and the new Treo is the first smart phone that doesn't require two hands for anything but entering text.

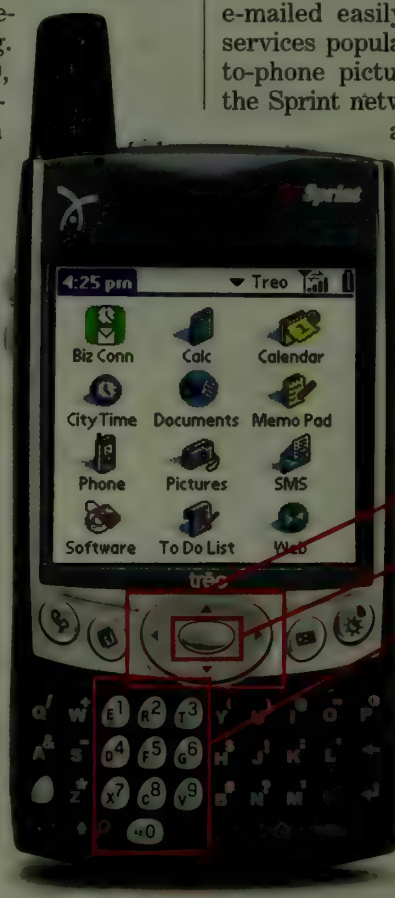
The most important change, oddly enough, is that the Treo works more like a PC. When you see an icon or menu item highlighted on a Macintosh or in Windows, you know it will be executed if you hit "enter." Treo brings this intuitive notion to a handheld. Instead of tapping a button or menu item with a stylus, you use the directional buttons of a five-way control (photo) to select an item, then click the center button to activate it. This all but eliminates the need for a stylus, and it makes a big difference.

In contrast to many of the smart phones I have tried, the Treo 600, which will sell for about \$500 with Sprint service, is first and foremost a

good phone. Battery life, an issue on earlier Treos, is rated at a respectable four hours of talk time and 240 hours of standby. You can dial a call by tapping an on-screen dial pad with a finger, using the 10-key number pad built into the keyboard, or by pressing and holding any key assigned to a speed-dial number. You also can select from a list of "favorites," which can be linked to Web pages or programs as well as phone numbers. Finally, you can start typing a name and matching address book entries pop up. Select the number you want, and the Treo will dial.

Like most high-end phones, the Treo includes a camera. The quality of the 640x480 pixel pictures is no match for a good digital camera, but they're not bad for a phone. The pictures can be e-mailed easily, although multimedia messaging services popular in Europe and Asia for photo-to-phone picture sharing are not available on the Sprint network, which doesn't yet offer even a text-only short message service.

The Treo gets wireless data at speeds equivalent to a fast dial-up connection on a PC, a feature Sprint offers unlimited data use for a \$10 monthly surcharge on a voice plan. Web pages load quickly, though the small display limits the usefulness of browsing. You'll be able to download games, other applica-



FIVE-WAY CONTROL

CENTER (SELECT) BUTTON

DIAL PAD BUILT INTO KEYBOARD

tions, and ring tones over the air from Sprint's PCS Vision service.

For most people, the main data use of the Treo will be e-mail. Sprint offers its \$5 monthly Business Connection service, which can forward e-mail from corporate accounts to

wireless devices and fetch mail from standard Internet accounts. Unfortunately, the Treo 600 version of the software was not ready in time to test the service.

I did, however, get to see the full potential of the new Treo by running Good Technology's GoodLink. It requires corporations to install special server software as an add-on to Microsoft Exchange, but it makes new mail, and contact and calendar changes, along with any other Outlook folders you use, available on the Treo. It's like having your desktop in a handheld.

I don't think the smart phone is likely to replace standard handsets. Most folks use phones primarily for voice calls and, increasingly, for text messaging and picture sharing. For them, a smart phone adds bulk and cost for limited benefit. But for those who want more, especially business users, the Treo 600 sets a new standard.

BusinessWeek online

LOOKING FOR A POCKET PC PHONE? Read about the Hitachi G1000 from Sprint in Technology & You at www.businessweek.com/technology/

Steve Wildstrom's Tech & You also can be seen every weekend on **BUSINESSWEEK TV**. Check local listings for details.

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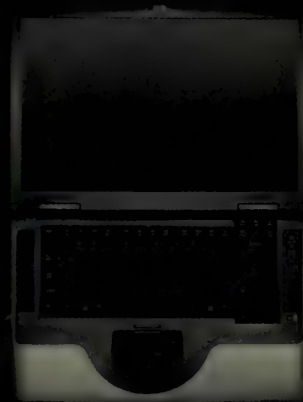
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BY ROBERT J. BARRO

THE STUBBORN JOBLESS RATE: PUZZLING, BUT FAR FROM SCARY



HYPE:
The Dems say the labor market is the worst since the Depression. But the drop in jobs has been milder than in many other recessions

With the start of the Presidential campaign season, one has to expect a rise in spurious economic claims. Nevertheless, I was surprised by the assertion from several Democratic candidates that the current U.S. labor market is the worst since the Great Depression of the 1930s. This claim has no basis in fact. Measured by unemployment rates or employment growth, the recession of 2001 and its aftermath was not as bad as many post-World War II recessions, notably 1948-49, 1957-58, 1981-82, 1953-54, and 1974-75. The downturn was more comparable with the mild recessions of 1960-61, 1970, and 1990-91.

When gauging a weak labor market, most economists look first at the unemployment rate. This rate, now 6.1%, peaked in the aftermath of the latest recession at 6.4% in June of this year. In contrast, during previous recessions, the jobless rate reached 10.8% in November, 1982; 9% in May, 1975; 7.9% in October, 1949; and 7.5% in July, 1958. The current 6.1% rate is only modestly above the average of 5.6% since January, 1948.

Instead of just looking at how high the jobless rate is, economists often look at how much it has risen during a recession. In the recent slowdown, the unemployment rate increased 2.5 percentage points, from 3.9% at its low point in December, 2000, to 6.4% in June. This rise is substantially smaller than those during the major postwar recessions: 4.4 points in 1948-49, 3.9 in 1974-75, 3.8 in 1957-58, and 3.6 in 1981-82 and 1953-54. More comparable are the increases in the unemployment rate by 2.6 points in the recessions of 1970 and 1990-91 and 2 points in 1960-61.

A more interesting perspective emerges when one looks at employment growth. Let's consider the most commonly used measure, the total non-agricultural employment series from the Bureau of Labor Statistics. Employment peaked at its all-time high of 132.6 million in February, 2001, and fell to 129.8 million in August, 2003, a 2.1% decline. This percentage decline is much smaller than those in the major postwar recessions: 5.2% in 1948-49, 4.4% in 1957-58, 3.4% in 1953-54, 3.1% in 1981-82, and 2.8% in 1974-75. More similar to today's situation was the fall by 2.2% in 1960-61. For 1970 and 1990-91, the decreases were 1.5%.

Although we clearly can reject the claim that the current labor market is the worst since the Great Depression, we still want to know why employment growth has remained negative despite the recent pickup in gross domestic product

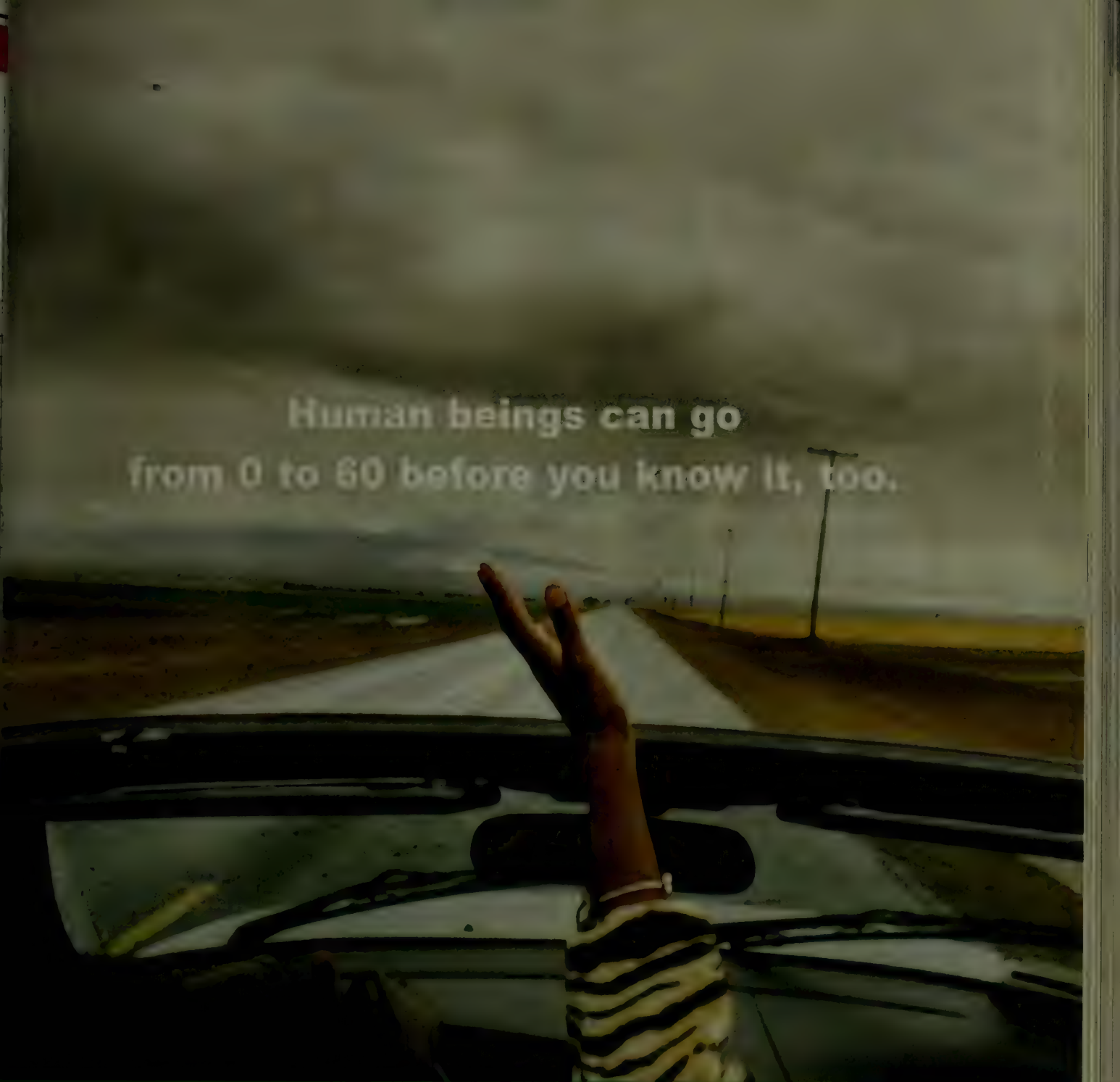
growth. One common explanation is that employment growth and the jobless rate are lagging indicators. There's some truth to this. When GDP changes, some of the shift in employment shows up only after one or two quarters. But most of the change usually occurs within the same quarter as the change in GDP. Moreover, even a one- to two-quarter lag would not explain why employment growth has remained sluggish for 2½ years now. Given the historical link between GDP growth and employment, job growth has been lower than expected in the last nine quarters. This extremely unusual pattern suggests that some basic change may have occurred in the relation between employment and GDP growth.

One way to look at the change is that the GDP growth required to get positive employment growth has risen substantially. In the long-term relationship, employment growth tended to be positive whenever GDP growth was mildly positive—only something less than 1% GDP growth was required. Since 2001, however, GDP growth apparently has had to exceed 2.5% to 3% for employment to begin climbing. That's why employment is still decreasing.

The other way to look at the numbers is that since GDP growth has been positive and employment growth has been negative, the economy has been able to produce more goods with fewer workers. In other words, productivity measured by GDP per worker has been rising strongly. (An adjustment for hours worked strengthens this scenario.) Since the second quarter of 2001, productivity has grown by 3.1% a year, compared with the long-term average of 1.4%. The key question is how long this high productivity growth will last.

If the high productivity gains continue, the economy will benefit tremendously for many years to come. In the longer term, employment growth corresponds to increases in the labor force, which depends on trends in population and labor-force participation. If the labor force expands at its long-term average of 1.5% to 2% per year, employment growth will be about the same. To determine long-term GDP growth, we have to add the productivity growth rate. Thus if productivity grows at 3.1%, the GDP growth rate would be around 5%, compared with the historical average of 3.3%. That would be very nice. For Republicans, an important question is whether this pleasantness will materialize by election time in 2004. That is a question I cannot answer.

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu).



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A black and white photograph of four business professionals (three men and one woman) walking towards the camera in a modern office hallway. They are dressed in business attire. The woman on the left is carrying a briefcase. The man in the center is holding a folder. The man on the right is holding a small object, possibly a phone or a small folder.

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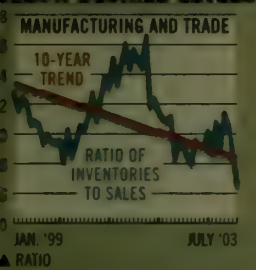
A TEMPORARY REPRIEVE FOR MANUFACTURING

But as order books are postponing the pain of long-term structural change

U.S. ECONOMY

After three years of declines, manufacturing is finally showing signs of recovery. But don't cue the Hallelujah chorus. All of the factory sector's strength is coming from traditional business-cycle forces. These demand-driven gains will improve factories' fortunes in coming quarters, but they won't reverse the long-term structural shifts that will continue to erode the sector's importance to the economy and payrolls.

INVENTORIES ARE WELL BELOW DESIRED LEVELS



Data: Commerce Dept., Global Insight Inc., BW

service jobs. And manufacturing's productivity surge in recent years means the sector is a key contributor to higher standards of living in the economy.

Manufacturing's cyclical upturn shows up in the latest data. Better demand has cut inventories to the bone (chart), triggering renewed ordering for both consumer goods and capital equipment. Excluding blackout-related shutdowns at auto plants, factory output has risen for four months in a row. And purchasing managers said industrial activity in August was the busiest far this year.

This good news is a switch from the last three years, when industrial output generally subtracted from real gross domestic product, and factory layoffs accounted for all of the job losses since the recovery began in November, 2001. Jobs aren't likely to come back soon, but manufacturing should add a dash more strength to the economy in the second half.

OPTIMISM ABOUT MANUFACTURING

goes hand-in-hand with the economy's new momentum, which should carry into 2004, say business economists. The National Association for Business Economics released its consensus of member forecasts at their annual meeting in Atlanta on Sept. 15. The group expects real GDP to grow 2.6% this year and by 4% in 2004. Those projections were better than NABE's May survey, which fore-

cast that real GDP would grow 2.3% in 2003 and 3.6% in 2004. The group expects stronger consumer spending and business investment in equipment.

Faster demand is the key cyclical force pumping up factory activity right now. In August, retail sales rose 0.6% after a 1.3% jump in July. Real consumer spending is on track to grow at an annual pace of 5% to 6% in the third quarter. That would be the fastest clip in almost two years.

More important, consumers aren't shouldering the economy's entire load anymore. Led by demand for tech equipment, shipments of business capital goods were up strongly in June and July, while real merchandise exports have increased in six of the last seven months (chart). At their present paces, capital-goods sales and exports in the third quarter could post their best quarterly advances since the late 1990s.

Plus, the growth rate in demand shows few signs of easing in the fourth quarter, thanks in part to the July tax cuts as well as very accommodative financial conditions. As expected, the Federal Reserve kept the federal funds rate at a 45-year low of 1% at its Sept. 16 meeting. The Fed noted that the economy was firming up, but it also indicated that labor markets were weak and that it would keep the funds rate low for quite a long time.

THE RECENT RISE IN DEMAND is helping to clear out inventories. From March to July, sales at manufacturers, wholesalers, and retailers jumped at a 4% annual rate, but their stockpiles dropped 1%.

Of course, inventories have been falling in relation to sales over the past 10 years. Thanks to computer tracking and just-in-time inventory management, businesses can carry fewer goods than they needed a decade ago. But the current level of inventories seems far below the desired amount. Based on the historical trend in the ratio of inventories to sales, the desired ratio should be greater than 1.38. Instead, the July ratio was a record low of less than 1.37.

No wonder businesses are buying again. Factory orders in July rose 1.6% after gaining 1.9% in June. And the Institute for Supply Management said ordering in August was even faster than in July. That was

FOREIGN DEMAND IS PICKING UP, TOO



true for overall bookings and exports by themselves.

Fatter order books, in turn, are causing factories to lift production. Output at the nation's factories, mines, and utilities rose 0.1% in August, lifted by a 1.9% advance in power use. Factory output alone dipped 0.1%, but the Fed said the mid-August blackout caused auto output to plunge 2.6%. Excluding vehicles, factory output edged up 0.1%, its fourth consecutive gain.

Leading the uptrend has been the production of high-tech gear. The production of computers, office machinery, telecom equipment, and semiconductors has increased so far in every month of 2003, and it now stands 12.1% above its year-ago level (chart).

DESPITE THIS GOOD NEWS, it is hard to be sanguine about manufacturing's prospects over the long haul. The sector is facing a clash of two different sets of economic forces. Right now, cyclical trends, the result of demand growth, policy decisions, and financial conditions promise to lift the factory sector.

But it is structural change, caused by the *Sturm und Drang* of technology, knowledge, and business practices, that keeps diminishing manufacturing's strength. First, the U.S. is shifting to a more service- and knowledge-oriented economy. Like agriculture before it, manufacturing accounts for a decreasing share of the dollar value of total output.

Second, as the U.S. workforce becomes more edu-

cated and expensive, domestic production of low-end goods can no longer be financially justified. The merchandise cannot compete with cheaper imports. More U.S. demand is being satisfied by foreign producers by American-labeled goods that are made offshore.

Lastly, the uptrend of higher productivity has enabled factories to make more with fewer workers. In the past 10 years, output per work hour for all nonfarm businesses has grown an impressive 28.7%. But factory efficiency has shot up 47.3%.

These structural forces aren't new, but they do explain why factory jobs account for only 11% of all non-farm jobs, down from 27% in the 1960s. And they're the reason why manufacturing did not increase its share of GDP, even during the late 1990s, which were boom years for tech production.

For the next few quarters at least, sustained growth in demand means that better times are ahead for factories. That's what typically happens when a recovery starts in earnest. But the tide cannot be held back. Manufacturers will enjoy the benefits of expansive cyclical forces, but they will still be at risk from the erosion caused by structural forces.



SOUTH KOREA

HOPE IN A BRIGHTER EXPORT OUTLOOK

South Korea is emerging from its worst downturn since the Asian crisis in 1998, but a full recovery is still a way off.

Real gross domestic product fell 2.9% in the second quarter after a 1.6% drop in the first quarter. The government crushed consumer spending when it clamped down on consumer credit late last year. Plus, exports suffered from the war-related global slowdown and the SARS epidemic in Asia.

Now, economists agree that a recovery is starting to take hold, but that it faces stiff headwinds. Household balance sheets remain under pressure from last year's borrowing binge and job losses. Also, even though

the stock market is up sharply, an increasing amount of Korean investment is going to China. "The Korean economy is now caught in a vicious circle of poor investment, lack of new employment,

and poor domestic consumption," says Huh Chan Guk, chief economist at the Korea Economic Research Institute, a *chaebol* think tank.

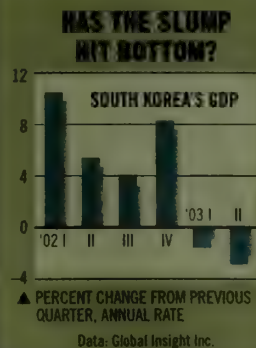
Making matters worse, strikes by workers in the transportation, auto, shipbuilding, and chemical

industries over the past two months have crippled industrial production. Then, as container loading for exports at the bustling Pusan port was finally getting back to normal, damage from Ty-

phoon Maemi will further curtail port activity. The unusually long rainy season is also hampering farm output and construction. Economists generally expect growth of about 3% this year and 4% to 5% in 2004.

Exports, which account for some 40% of GDP, will lead the recovery, and the outlook there is improving. August export growth slowed to 11% from 16% in July, but that was a strong showing given the effects of the strikes. Business confidence in August rose to its highest level in almost a year. The healthier outlook for Korea's foreign markets, especially in Asia, should keep exports on the upswing. Gradually, that will boost profits, business investment, and hiring, which will help to get households spending again.

With Moon Ihlwan in Seoul



DOES IT ALL

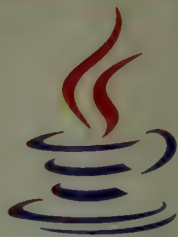


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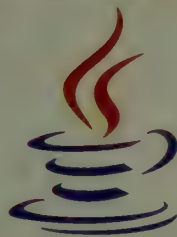


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BIG CHANGES FOR THE BIG BOARD

With Grasso gone, the New York Stock Exchange looks set for an overhaul

For a man as thin-skinned, vain, and publicity-conscious as Richard A. Grasso, it must have been hell. Day after day, from almost the moment the full details emerged of his \$188 million pay package on Sept. 9, the 57-year-old chairman of the New York Stock Exchange has been the subject of an almost unprecedented tide of private maneuvering—with even his old allies on the trading floor turning against him—and public revulsion. Grasso remained defiant, but in the end, the pressure was too intense. With opposition mounting from his board and the trading floor, heat from the Securities & Exchange Commission, and increasing calls for his ouster, Grasso resigned on Sept. 17.

Grasso's downfall was stunning in its swiftness. And beneath the mounting criticism was a sobering reality for the 211-year-old Big Board as it struggles to salvage its tarnished reputation as the gold standard of the financial markets. Now that Grasso is gone, the NYSE is likely to undergo far-reaching structural and regulatory changes. The controversy over Grasso has come at a crucial time for the NYSE, and the furor over his pay has shone a spotlight on an already simmering debate over its weak governance. Since March, the SEC had been prodding the NYSE to

review how the exchange runs itself—a process that was supposed to culminate on Oct. 2, when an NYSE committee, chaired by former New York Comptroller H. Carl McCall and President Clinton's former Chief of Staff, Leon Panetta, planned to announce its slate of governance changes. Grasso had called a special meeting for Sept. 24 to discuss the proposals. Grasso felt "he is a persuasive fellow, and he wants to talk [his opponents] out of it," says a source close to one board member.

But as calls for his departure mounted, with Presidential candidates Senators John Edwards (D-N.C.) and Joseph I. Lieberman (D-Conn.) joining the chorus, the board called a special meeting. Grasso realized he could not survive. The board initially picked as interim chairman a Grasso loyalist on the board, prominent Silicon Valley lawyer Lawrence W. Sonsini. As *BusinessWeek* went to press late on Sept. 17, another

board meeting was still ongoing and Sonsini had not yet accepted the post.

The NYSE's new governance proposals will now have to contrast dramatically with the anemic initial ones announced in June. Otherwise, the SEC will likely force real change on the exchange. "I think they're going to have to start from scratch," says Muriel Siebert, the first female NYSE member, who now heads discount brokerage Muriel Siebert & Co.

Although the SEC is publicly waiting to see what the NYSE says, back-channel communications between the Big Board and its overseer have been intense. Some NYSE members had flown to Washington in recent days to meet with high SEC officials to press the case against Grasso. The mood at the SEC is impatient. In the end, an independent panel—or a small group of directors who played no role in setting Grasso's pay—may wind up supervising the delicate task of overhauling the exchange. "The NYSE board, as it currently exists, cannot credibly review its own actions," says a top SEC official.

Some areas where change is likely:

WHAT MAY BE IN STORE

In the debate over the need for a makeover of the NYSE's structure and governance, here are some of the proposals:

DISCLOSURE Ensure that the NYSE's disclosure practices are changed so that they match those of public companies.

LEADERSHIP Split the NYSE chairman's post from the CEO's by appointing a nonexecutive outside director as chairman.

DIRECTORS Ensure that most NYSE board members are not employees of firms regulated by the exchange.

REGULATION Shift regulatory authority, totally or in part, from the NYSE to a separate oversight agency.

■ **FULL DISCLOSURE.** The NYSE and other stock markets are subject to few disclosure requirements unless they are public companies themselves. In its June proposals, the NYSE agreed to publish the salaries of its top officials. But pension funds and other institutions, led by the trade group Council of Institutional Investors, want the NYSE to follow the same rules as NYSE-listed companies. This goal is also being pursued by an interest group with a far different agenda—ex-

change members, whose fealty to Grasso abruptly eroded after the revelation of his enormous pay package. Dissident members say they were particularly stunned by the \$5 million bonus to Grasso after the September 11 attacks.

■ BOARD COMPOSITION. An overhaul is likely for the NYSE board, from its nominating process to its makeup. It consists of 27 members, of whom 12 are supposed to represent the interests of the public, though they are often corporate moguls. Some critics favor re-vamping the definition of "public" so that independent directors dominate—a process that may lead to the removal of top Wall Street executives, such as Goldman, Sachs & Co. Chairman Henry M. Paulson Jr., a leading advocate of Grasso's ouster. That would shift the balance of power to directors from outside the securities industry, such as former Secretary of State Madeleine K. Albright, a recent addition to the board who publicly backed Grasso while quietly pushing for his ouster, according to an aide to one board member. Albright did not return calls. According to an agency official, SEC Chairman William H. Donaldson believes some members of the current board have no credibility and should go but is leaving that decision to the board.

NYSE members have their own agenda. They are pushing for directors who represent the hundreds of members, estimated at 70% of the total, who lease out their seats. That is not likely to have much appeal to institutional investors. But all critics unite in wanting to end the NYSE chairman's input into board nominations, which has been tantamount to control of the selection process. The nominating committee would no longer have annual "audiences" in which the chairman puts forth a list from which the committee selects board members. The practice has drawn widespread criticism since it was revealed by Grasso in an interview with *BusinessWeek* (BW—Sept. 15).

■ THE TOP JOB. Grasso wore two hats—chairman and CEO. But those roles are likely to be split, with the chairmanship becoming a nonexecutive position. That would enhance the independence of the board. But not all governance critics are enthusiastic. Sarah A. Teslik, executive director of the Council of Institutional Investors and an outspoken critic of Grasso, says she has received "unofficial feelers" that the NYSE is moving in that direction. But "I don't know how much

difference it would make," she says.

■ REGULATION. A hot potato that was avoided by the NYSE governance committee's initial report, the issue can no longer be avoided: Many investors and others were outraged by Grasso's huge pay precisely because he regulated the companies that rewarded him so generously. One possibility under discussion is to move some or all regulatory functions to a separate organization, much as the regulation of the NASDAQ stock market was assigned to a separate institution in 1996. Representative Richard H. Baker (R-La.), chairman of the house

the Sept. 16 verdict of board men William B. Summers Jr., chairman of McDonald Investments Inc. in Cleveland. But that clearly wasn't the view of Goldman Sachs's Paulson, Morgan Stanley's Chairman & CEO Philip J. Pur and Albright, described by sources as to the board as the leading dissident.

Until the final moments, Grasso's ponents on the board were playing a waiting game. They hoped—ultimately correctly—that the onslaught of public pressure would force Grasso to quit. Anonymity was the order of the day, and fear of retribution was high. "W

GRASSO'S SWIFT FALL FROM GRACE



DONALDSON

MAR. 26 SEC Chairman Donaldson asks the NYSE for information on its governance practices.

AUG. 27 Under pressure to become more transparent, the NYSE for the first time discloses the salaries of its top execs—revealing that Grasso stands to take home \$140 million in compensation.

SEPT. 2 Donaldson demands details as controversy over Grasso's outsize pay package grows.

subcommittee on capital markets, observed on Sept. 17 that "the chairman of an exchange shouldn't be



GRASSO

paid for overseeing both the regulatory side and the business side."

Such proposals are unlikely to see final form until Grasso's ultimate successor is named. He had favored either of his two co-presidents, Catherine R. Kinney or Robert G. Britz. But their lavish pay packages and close association with Grasso made them non-starters. Should Sonsini not be appointed, others whose names have been floated as possible replacements include former SEC Chairman Arthur Levitt and John H. Biggs, former TIAA-CREF chairman.

Grasso loyalists insisted until the end that talk of succession was premature. "He's had the support of the board in the past, he has the support of the board in the present, and he'll have the support of the board in the future," was

SEPT. 9 The NYSE announces that Grasso is entitled to \$48 million more in compensation, but Grasso agrees to forgo it. The exchange releases 1,200 pages of salary documents that show a \$5 million bonus for Grasso's work after September 11.

SEPT. 16 California Treasurer Phil Angelides calls for Grasso's resignation. So do the heads of four of the country's largest public pension funds.



ANGELIDES

SEPT. 17 Under pressure from the board, Grasso resigns.

one phone call, [Grasso] can tell us we are under an investigation that will require 300 lawyers for 25 years," says a person close to one Wall street board member.

Another sobering factor was that, until the final moments, Grasso still had significant—if rapidly dwindling—cadre of admirers. Even a leading dissident exchange member—William Higgins—who is pressing for board membership for people who lease out their seats—wanted his colleagues to forgive and forget. Says Higgins: "When people make mistakes on the floor, we call that a QT—questionable trade. I tell people who call that Grasso had a QT, he should clean it up, clear the losses, and go on. But Grasso did much more than make a bad trade—and he paid the price for his unrelenting greed.

By Gary Weiss in New York and Paula Dwyer in Washington, with Marc Der Hovanesian in New York, and bureau reports

THE CANDIDATE FROM CENTRAL CASTING

Wesley Clark's outsider status is a mixed blessing

Most times, the late entry into the Presidential race of a political figure like former General Wesley K. Clark would be met with indulgent smiles from campaign pros. With months to go before Iowa caucuses, Clark, who entered the fray on Sept. 17 in his hometown Little Rock, seems to lack many of the essential weapons for the political arena: He has never held office, relies on a shop-around band of former Clinton aides for advice, and may be hard-pressed to raise the \$20 million-plus needed to match the likes of Howard Dean and John F. Kerry in the race.

The thing is, 2004 may be anything but a conventional election year—which makes it unwise to dismiss Clark's charge as a mere flight of fancy. Dragged down by a soggy economy and an increasingly troubled Iraq intervention, President George W. Bush is looking vulnerable. But in the post-Sept. 11 era, many Democrats still seek a standard-bearer with solid credentials in national security—a niche none of the current crop of contenders has filled.

GENERAL WESLEY K. CLARK



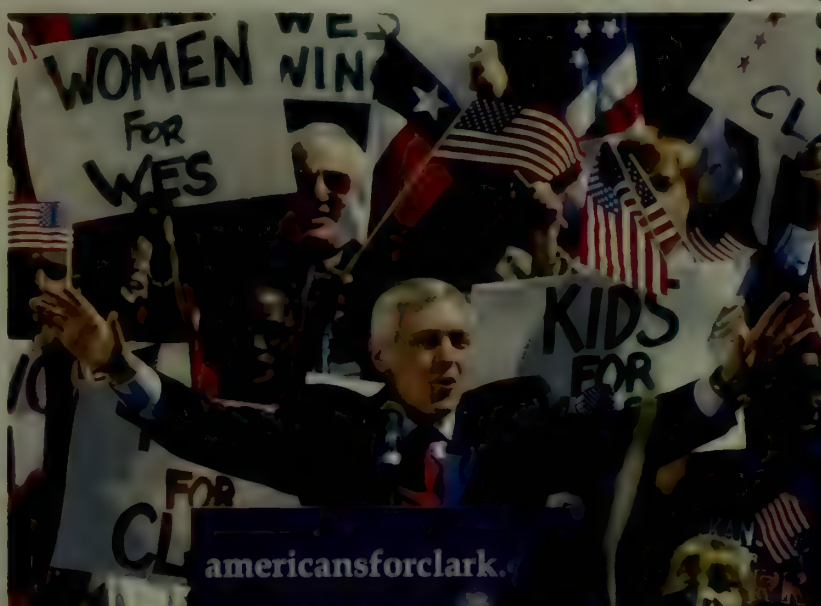
AGE 58

EDUCATION

Graduated first in class from West Point, 1966; Rhodes Scholar, Oxford University, 1968

MILITARY EXPERIENCE

Supreme Allied Commander Europe (NATO), 1997-2000;



WHITE KNIGHT? Clark's intelligence and studiousness are unquestioned—but at NATO he struck many as a showboater

Enter Clark, the candidate from Central Casting. After graduating first in his class at West Point and winning a Rhodes scholarship, he fought in Vietnam, leading a mechanized infantry company. In 1970, his unit came under enemy fire near Saigon. Clark, then 26, was shot four times. The injuries required a year of rehab and earned him a Silver Star for valor under fire.

By the time he was 52, Clark was Supreme Allied Commander Europe, a post from which he directed the 1999 NATO war against Serbian strongman

Commander-in-Chief, U.S. Southern Command, Panama, 1996-97; Commander, National [Military] Training Center at Fort Irwin, Calif., 1989-1991

RECENT NONMILITARY EXPERIENCE

Consultant for the Little Rock-based Stephens Inc., a controversial investment bank for which Clark was spotting high-tech

investments. Post-9-11 commentator for CNN

CAREER HIGHLIGHTS

Earned a Silver Star in Vietnam; led military negotiations for the Bosnian Peace Accords at Dayton, Ohio; freed Kosovo without U.S. casualties

BIGGEST CAREER DISAPPOINTMENT

Was replaced before his NATO tour of duty was up

Slobodan Milosevic. The 78-day air blitz won the hard-charging general international acclaim—and his share of enemies. Back at headquarters, Clark “was viewed as a self-promoter,” says one ex-Pentagon official.

Clark's greatest asset, friends say, is his innate intelligence. It's also his greatest liability. During his NATO days, the studious soldier struck many officers as a showboat. He alienated the Pentagon by arguing publicly for ground troops in Kosovo—options that proved unnecessary in light of ultraprecise bombing.

Ultimately, the jockeying cost Clark his command. Then-Defense Secretary William S. Cohen got his revenge by having the Arkansan dismissed three months early from his Brussels post.

No doubt about it, Clark the warrior-scholar was a different kind of general, and he figures to be a different kind of candidate. Despite a chestful of medals, he was an early foe of the preemptive war against Iraq. In books and lectures, he displays a coherent strategic vision and a belief in multilateral alliances—qualities Democrats feel have been lacking under Team Bush (page 40). Clark is positioned as

an outsider, but he has spent much of his post-military career hobnobbing with the Establishment. Moreover, his battle ribbons give him instant credibility to shape the attack on Bush foreign policy—credentials even fellow Vietnam vet Kerry can't match.

Enhancing his allure to party activists, Clark, 58, is a liberal on social issues such as abortion, gun control, and affirmative action. He would also repeal many Bush tax cuts for upper-bracket Americans while leaving lower rates in place for the middle class. That distin-

after Pentagon infighting

POLITICAL STRENGTHS

Highly decorated military background; Southern home base; articulate critic of Bush military strategy; grassroots support organized via the Web

POLITICAL LIABILITIES

Untested as a candidate, late entry in campaign; far behind other candidates in the money chase

guishes him from Dean, who wants to roll back much of Bush's \$3.5 trillion in cuts and favors an expensive health plan. "What this race needs is a centrist," says Clark adviser Skip Rutherford. "That's where Clark comes in."

While not discounting Clark, political pros say he faces long odds in his quest for the Presidency. Most point to Clark's lack of money. But with a candidacy as novel as his—the closest parallel is Dwight D. Eisenhower's 1952 run—donations could pour in quickly if the general shines in upcoming debates. Clark "will be a formidable candidate," says Senator Chuck Hagel (R-Neb.).

Adds a top GOP strategist: "If Dean is [White House political guru] Karl Rove's greatest fantasy, Clark is his worst nightmare."

Perhaps. But Clark is also about to be tested in the fast-paced environment of political combat. Among the key questions looming over his candidacy:

STUMP SAVVY. Clark has impressed CEOs and academics with his erudite geopolitical analyses at the World Economic Forum and elsewhere. But can he connect one-on-one with voters in New Hampshire *kaffeeklatsches*? "Wow-ing them in Davos isn't the same as wow-ing them on the rubber-chicken cir-

cuit," says Linda L. Fowler, a government professor at Dartmouth College. "No one really knows what kind of candidate Clark will be."

MONEY QUESTIONS. Top Democrats such as former Vermont Governor Dean, Massachusetts Senator Kerry, and Connecticut Senator Joseph I. Lieberman have commitments from prominent fundraisers. Some moderate businesspeople say they would be willing to cough up cash for Clark—but most are waiting to see if he catches fire in early polls. "The money will come if Clark proves he's for real," says one party pol. "The first he has to prove it."

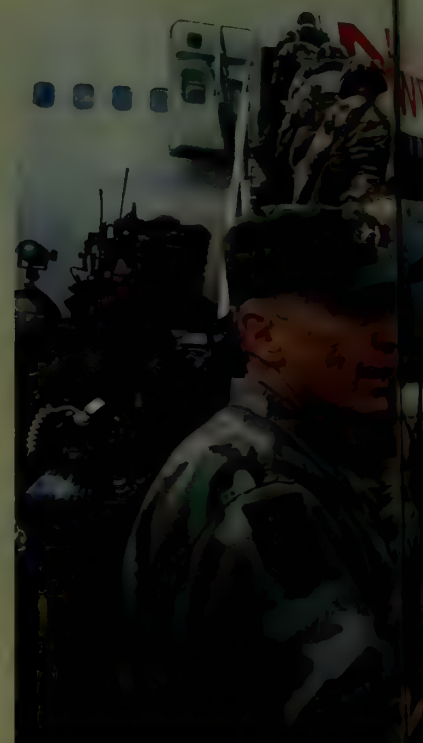
CLARK: WHAT'S WRONG WITH U.S. POLICY IN IRAQ

As General Wesley K. Clark wades into the Presidential race as a Democrat, his views on Iraq, the terrorist threat, and national security should be of utmost interest to the electorate. His new book, *Winning Modern Wars: Iraq, Terrorism and the American Empire* (PublicAffairs, 2003), is, in effect, Clark's campaign manifesto, providing insights into what he believes and what he would do as Commander-in-Chief. As a book, it is a smart take on the battlefield tactics used in Iraq as well as a tough-minded critique of the military strategy and the geopolitical doctrine followed by the Bush Administration. With the campaign heating up and talk of an Iraqi "exit strategy" growing, Clark's book offers a vision that contrasts sharply with that of President George W. Bush. Agree or disagree with the four-star general, here is what he says:

■ The war in Iraq "has thus far been a perfect example of dominating an enemy force but failing to win the victory." Clark says the Administration made the classic mistake of equating the defeat of an enemy with achieving its larger political goal. That goal was to set up a democratic, stable, secular Iraq which

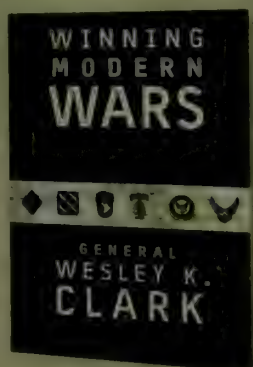
would help stop terrorism. Clark argues that this required higher force levels and a different strategy: "Victory means not the defeat of the opposing army but rather winning the follow-through operation to accomplish the aims and intent of the plan." Too few troops on the ground going in left Saddam's Sunni heartland unconquered and rearguard supply troops vulnerable to attack. Moving unilaterally meant there were no European or other foreign troops to help in combat or policing the peace. And inadequate postwar planning meant few Arabic-speakers on hand, hardly any power generators, and no portable communications equipment. The Pentagon's war strategy, in effect, had "a profound flaw—the endgame."

■ The war in Iraq has weakened, not strengthened, the fight against terrorism "by diverting attention, resources and leadership, alienating allied supporters and serving as a rallying point for anyone wishing to do harm to the U.S. and Americans." Clark, who was publicly against the war from the start, argues



that the Bush Administration failed to make the case that Iraq was an imminent danger. More important, the administration was caught up in the War policy template of fighting not supranational terrorists such as Qaeda, and was predisposed to a Iraq well before September. Defense Secretary Donald H. Rumsfeld and others believed that state-sponsored terrorism was the problem and that regime change could end the terrorist threat to the U.S.

Wrong, says Clark—this policy is making the U.S. less secure. Safe



IRAQ has thus far been a perfect example of dominating an enemy force but failing to win the vic-

UES LAND MINES. Right now, Clark's is top-heavy with views on national security. As he fills in the blanks on his stands on taxes, jobs, and education, he may be tempted to tack left in order to appeal to the activists who dominate primary voting. Too sharp a tilt, however, could imperil Clark's outer status—a potent lure for independent voters who can tilt the outcome in states such as New Hampshire and South Carolina. "Pandering to interest groups," says a GOP official, "could taint Clark the notion of being a straight shooter."

CLINTON CONNECTION. While former President Bill Clinton, with whom Clark dines regularly, has encouraged him to run, the association could back-

fire. Many top Clintonites, such as former White House *consigliere* Bruce Lindsey, are advising the general. But those links and Clark's nearly three-year stint at Stephens Inc.—a controversial Little Rock investment firm that often mixes money and politics—may revive memories of Arkansas' hot-house politics.

TEMPERAMENT. During his NATO stint, Clark earned a reputation as a prickly leader with sharp elbows to match. He irked Pentagon suits by taking his concerns over the air-only war in Kosovo to White House pals, and irritated military officers by turning on a dime to take credit for the successful air campaign. As a result, "Clark doesn't have a lot of friends at the Pentagon," says

Chester A. Crocker, a professor at the School of Foreign Services at Georgetown University and a former Assistant Secretary of State under Reagan. The big question for Campaign '04: Will the general morph into an Alexander Haig-style control freak when the campaigning gets rough?

Clark's advisers feel the fears overblown. Yes, the general with a penchant for intellectual treatises is a political greenhorn, they say. And that's just the quality his advisers hope will propel their hero to the head of the Democratic pack—and all the way to the White House.

By Lee Walczak and Richard S. Dunham with Stan Crock in Washington



U.S. Army general, places the current debate over transforming the military within a broader fight between the Air Force and Army that goes back to World War II. This is one of the more intriguing aspects of his book. Clark says that the Air Force has been trying for decades to prove that it can win wars alone, without the Army, through decisive and devastating air power. Rumsfeld, of course, is an ex-Navy pilot and a believer in air power. Clark concedes that air power won out in Serbia and Kosovo. But while he backs high-tech warfare, Clark also sees boots on the ground as essential. Special Ops units working with the Air Force couldn't destroy al Qaeda, but a division of Army soldiers might have. "It was a strategic opportunity lost."

CLARK IN 1993: ■ Iraq may destroy the all-volunteer Army. Rotating troops home is needed to keep up morale

Clark spends dozens of pages exalting the bravery and abilities of the men and women of the armed forces in his book. But he warns that the U.S. Army is not an army of occupation. The "quasi-imperial" America envisioned by the neocons in the Bush Administration is not matched by the military force that is supposed to create it. Nor should it be, according to Clark. He argues that the U.S. military is built for war-fighting, not long-term policing. It is a relatively small force (just 500,000 active Army troops), composed of volunteers, many of whom are married, with family commitments. Rapid and frequent rotation back to families for the enlisted—and to their jobs for the reservists—

is crucial to maintaining the volunteer force. With Iraq tying down so many troops, that's not happening.

■ American unilateralism is bad military policy and bad foreign policy. Clark sharply criticizes the 2002 National Security Strategy of the United States of America paper that postulates a unilateral, preemptive foreign policy for the country. He argues that the U.S. leverages its military and political power around the world through multilateral institutions such as NATO and the U.N. and that abandoning them has cost it dearly in Iraq. In effect, he says that the U.S. doesn't do nation-building very well and should outsource it to the U.N. Clark also dislikes talk of an American Empire. "Old ideas of empire have to be replaced with a new strategic vision."

That vision, of course, is the exit strategy out of Iraq. Clark says the U.S. must return to its multilateral roots and get Europe to share the burden in Iraq. He concedes that NATO and the U.N. need reform but says this can occur only through constructive U.S. leadership. Above all, he says the military should be powerful enough to achieve its goals but be used only as a last resort and with allies, if possible. Sounds much like the Powell Doctrine.

Winning Modern Wars succeeds on many levels, including the Stephen E. Ambrose-like description of battles and tactics used by General Tommy Franks in pacing the war. Clark clearly admires the courage and capabilities of the soldiers on the ground. But he also presents a cogent critique of Pentagon leadership and White House politics. As a military man, his insights go beyond the predictable Republican-Democratic partisan dialogue. It's a valuable perspective no matter which candidate you vote for.

By Bruce Nussbaum in New York

Example of dominating an enemy

— WESLEY CLARK



THE GLOBAL ECONOMY

BUILDING TOWARD A RECOVERY

Growth is picking up around the world as countries slash taxes and cut rates to spur demand

As the U.S. economy has struggled to recover over the past 21 months, weak global demand has been like a ball and chain holding it back. Foreign companies, faced with slack demand and overcapacity at home, have flooded the U.S. with imports. And U.S. exporters have had a tough time making much headway overseas. Put the two together and foreign trade has subtracted some two-thirds of a percentage point off annual U.S. growth since the economy bottomed out in the fourth quarter of '01. That may not seem like much, but it has been enough

to keep the U.S. economy from attaining the sort of cruising speed necessary to generate more jobs and put the recovery on a sustainable flight path.

Now, though, the global economy looks to be turning. In a forecast prepared for its annual meeting in Dubai on Sept. 23-24, the International Monetary Fund (IMF) predicts that world economic growth will accelerate to 4.1% next year from 3.2% this year and 3% in 2002. Much of that, of course, is due to stronger demand in the U.S. Some economists now see growth of close to 6% in the third quarter, thanks to tax cuts, a boost from defense spending, and stepped-up capital investment.

The global upswing, though, is not only a made-in-the-USA affair. Japan, the world's second-largest economy, is picking up and starting to generate home-grown growth, rather than just relying

DIZZYING

A worker in Wuhan. China's growth is on a tear

on exports for a boost. Emerging economic power house China has shaken off the SARS scare and, on a tear, with sales of everything from autos to construction materials booming. Even in Europe, where the economy all but stalled in the first half, there are signs of life, with business confidence starting to perk up. "We are not out of the woods, but we are clearly in a better situation than earlier this year," IMF Managing Director Horst Köhler said on Sept. 12.

The broadening of the global expansion bodes well on many fronts. Global trade talks in Cancun broke down on Sept. 14, in part because the weakness of the world economy made it difficult for the U.S., Europe, and developing nations to make concessions. Faster growth and increased prosperity don't guarantee that the talks can be restarted next year, but certainly

ly increase the chances they may be.

More concretely, the global upswing should help hard-pressed U.S. manufacturing companies. Still hemorrhaging jobs, they remain a weak link in the economic recovery. "We're starting to see business levels improve," says Theodore Solso, chief executive of Cummins Inc., a maker of big engines based in Columbus, Ind.

Indeed, U.S. exports are on the rise and hit their highest level in more than two years in July. Part of that gain, of course, has been due to the weakening of the dollar over the past 18 months, which has boosted the competitiveness of U.S. companies, particularly vis-à-vis their European rivals. In a bid to give manufacturers a bigger lift, U.S. Treasury Secretary John W. Snow is expected to press both China and Japan at the IMF meeting in Dubai to allow the currencies to appreciate against the dollar. While China is unlikely to agree, traders are betting that Japan may be more amenable.

Stronger overseas demand, coupled with a lower dollar, is even raising hopes that the relentless rise of the U.S. trade deficit may be nearing an end. True, a further increase in red ink seems likely in the coming months as the supercharged U.S. economy sucks in more imports. But some economists are forecasting the deficit will crest near

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year, at least as a percentage of gross domestic product. "The current-account deficit will peak over the next year and hopefully head down in 2005," says former IMF chief economist Michael Mussa.

Admittedly, the widening recovery is only the first step toward a needed rebalancing of global demand. It will probably take a further fall of the dollar, and even faster growth abroad, to wean the world economy off its

over-dependence on the U.S. "The path to a more balanced global economy will require further [action]. But this [expansion] is an important step," says J.P. Morgan Securities economist Bruce Kasman.

It's a step policymakers can claim some credit for. After all, they've pumped massive amounts of money into their economies. "We haven't had such a flood of liquidity since the time of Noah," quips Robert D. Hormats, vice-chairman of Goldman Sachs International. The U.S. has led the charge by slashing income taxes and reducing short-term interest rates to their lowest level in 45 years. But countries from South Korea to Germany have also cut taxes while central banks worldwide have opened the monetary spigots.

The global growth strategy is beginning to pay off. Japan's long-troubled economy grew faster than that of the U.S. in the second quarter. Most of that growth came from stronger domestic demand. Forced to live with debilitating deflation over the past six years, Japanese multinationals have slashed costs and boosted efficiency. And despite ongoing problems in Japan's banking system, corporate profits are rising and businesses are using that money to step up investment. Capital spending was up more than 5% in the second quarter.



tounding 60% and could 2 million units this year.

In contrast to Asia and the U.S., Europe still lags behind in the growth game—in part because policymakers there have been more timid than their U.S. and Asian counterparts in trying to stimulate demand. There are signs, though, of better times ahead. In Germany, manufacturing is starting to pick up for the first time in months. And in France, new business creation

Stronger overseas demand and the weaker dollar are raising hopes that the relentless rise of the U.S. trade deficit may be near an end

SHIPPING CONTAINERS AT PORT NEWARK, N.J.

U.S. companies are beginning to reap the benefits. "We're starting to see significant improvement [in Japan]," says Network Appliance CEO Daniel J. Warmerhoven. Adds Cisco Systems CEO John Chambers: "It's the most optimistic I've seen Japanese business and government leaders...in a decade." Japan and much of Asia are benefiting from strong demand in China. While China has a growing and controversial trade surplus with the U.S., it's deeply in the red to the rest of Asia. Indeed, China looks set to supplant America as South Korea's top export market.

And thanks to an aggressively expansionary monetary policy that has boosted the money supply by 20% over the past year, Chinese demand is booming after a SARS-induced hiccup. In Beijing, restaurants are crowded again and it's hard to get taxis. After slowing in June, retail sales rose at a year-over-year rate of nearly 10% in August. Sales of automobiles have jumped an as-

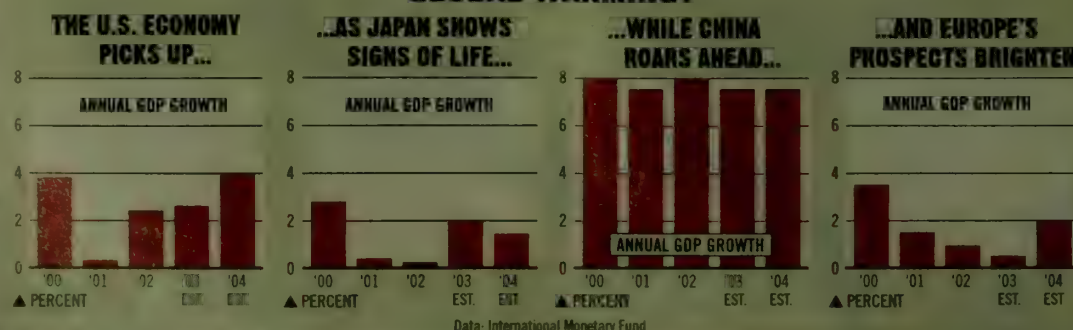
robust. "It's not all gloom," says Michael Heisse, chief economist at the Alliant Group financial-services firm. "There has been significant corporate restructuring and profitability is improving."

What's more, European politicians are finally beginning to press ahead with the painful reforms needed to boost efficiency and long-term growth. Against a grim backdrop of rising unemployment, German Chancellor Gerhard Schröder looks set to carry through on much of the pension and labor market reform program he unveiled in March. That's raising hopes for stronger growth in Germany, Europe's largest economy. Traditionally, German recoveries have followed an increase in exports. But this time, says Udo Rosendahl, portfolio manager at European money manager DWS, corporate investment and consumer demand will lead the way.

That's music to the ears of U.S. policymakers. For years, they've been warning America's trading partners against relying on exports for growth and prodding them to develop some internal demand of their own. Now, there are signs that's happening. That's good news—both for the U.S. and world economies.

By Rich Miller in Washington with David Fairclimb in Frankfurt, Brian Bremner in Tokyo, Dexter Roberts in Beijing, and bureau reports

GLOBAL WARMING?





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COMMENTARY

By David Welch

A CONTRACT THE BIG THREE CAN TAKE TO THE BANK

Finally, a silver lining to the cloud hanging over Detroit. After three years of watching profits weaken and market shares slide at the Big Three, the United Auto Workers agreed to a new labor deal that should help Detroit compete against foreign rivals. The union signed tentative labor contracts with DaimlerChrysler and Ford on Sept. 14 and 15—and a similar deal with General Motors should follow. All three deals will give the car-makers much-needed relief.

The deal won't solve all of Detroit's cost problems, but UAW President Ron Gettelfinger has agreed to close enough plants and cut enough jobs to allow domestic carmakers to pull close to—or maybe even surpass—rivals Toyota Motor Corp. and Honda Motor Co. in productivity. That would mark a major milestone for the Big Three, because they've lagged behind the Japanese in efficiency for nearly a generation. So far, the union has agreed to let Ford and Chrysler close or sell 11 plants collectively. GM is expected to get a similar deal that would allow it to cut up to 18% of its workforce.

Overall, the new pact should eventually chop about \$300 per vehicle off Detroit's costs, bringing its factory labor bill roughly in line with those of the Japanese transplants for the first time. That's great news, but not quite so great as it sounds. The Big Three must still wrestle with their colossal pension and medical costs, which run about \$450 more per vehicle at Chrysler—and a staggering \$1,200 more at GM—than at their Japanese rivals. Still, "they won't be able to blame the union anymore," says Sean McAlinden, chief economist at the Center for Automotive Re-

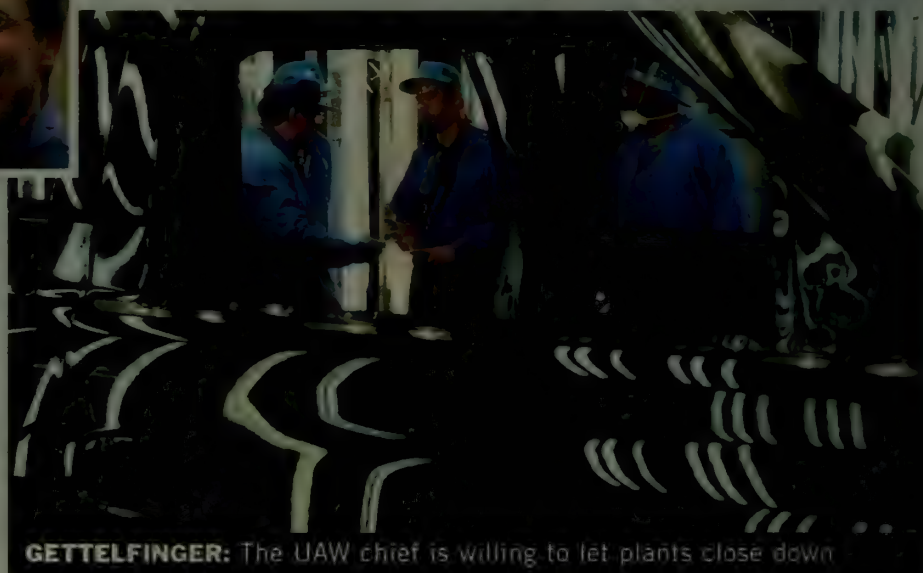
search, located in Ann Arbor, Mich.

GM has the best shot at surpassing Japanese productivity. Its plants need just two hours of labor more to build a car than those of Toyota and Honda. While GM has improved its productivity by 23% during the past six years, Toyota's productivity, for instance, has remained relatively flat.

The auto giant, however, isn't likely to reach the level of Nissan's single U.S. factory, which

ly improve unless it can at least keep sales near current levels. Domestic market share has fallen almost two percentage points, to 60%, this year. If share continues to slide, then Detroit won't be able to cash in on its workforce reductions.

And overly aggressive cost-cutting, of course, can hurt quality. In 2001, for example, a supplier to GM's new Cadillac plant in Lansing, Mich., sent preassembled body parts that



GETTELFINGER: The UAW chief is willing to let plants close down

is more efficient than all the others because it was engineered to run with a lean workforce and makes models that are less complex than those made at many Big Three plants.

Despite the new leeway from the union, Detroit must still hustle to achieve all the possible productivity gains. To match Toyota, GM will have to shed 13,554 jobs, Ford needs to lose 17,400 workers, and Chrysler Group about 12,000. Since they all have excess capacity, over time those job cuts could pull the Big Three close to Honda and Toyota. The average age of Big Three workers is 46, and half will be eligible to retire in the next five years. The domestic auto makers will replace only a fraction of those workers.

Detroit's productivity won't actual-

ly didn't fit the cars properly. To fix the problem, GM had to bring the work back into its own plant. Says McAlinden: "GM found there are limits to how much they can [outsource]."

The auto makers will pay a price to shrink the workforce. In addition to their roughly \$15 billion in annual health and pension outlays, the Big Three granted \$3,000 bonuses this year and raises of 2% and 3% in the third and fourth years of the contract. Says Cole: "Legacy costs will continue to be a problem."

That's no doubt true. In this deal, the Big Three will still be handing out big benefits to retirees. But at least Detroit is making progress cutting its famously bloated labor costs.

Welch covers autos from Detroit.

CAN DETROIT CLOSE THE GAP?

► A new labor pact will help U.S. carmakers catch up with Japanese rivals

Data: Harbour & Associates Inc.

LABOR HOURS PER VEHICLE

CHRYSLER

28

FORD

26

GM

24

TOYOTA*

22

HONDA*

22

NISSAN*

17



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TECHNOLOGY

MICROSOFT: A KILLER APP THAT COULD KILL THE COMPETITION

Its entry into the antivirus market has rivals spooked

It's a great time to be in the antivirus business. In August, two separate bugs laid low millions of PCs around the world, causing an estimated \$2 billion in damage. Both exploited vulnerabilities in Microsoft Corp.'s Windows operating system. And on Sept. 10, Microsoft warned of yet another security hole in Windows that could lead to a new bout of bugs. All that has sent sales of antivirus software soaring. So which company stands to benefit the most from the surging demand for security software? That's right: Microsoft.

The software giant recently closed a deal that could help it dominate consumer antivirus software. On Sept. 3, Microsoft acquired the technology of Gecad Software, a Romanian software maker, for an undisclosed sum. Analysts expect Microsoft to bundle Gecad's software with the next iteration of Windows, due out in 2005. That could virtually eliminate competition in the consumer market for antivirus software now dominated by Symantec Corp., Network Associates Inc., and others. Says Laura Koetzle, a senior analyst at Forrester Research Inc.: "Microsoft will eventually monopolize the business."

There's more than a little irony in that. Critics have long blamed Microsoft for much of the virus epidemic, arguing that the company has worried less about security than about getting new products out the door. Vulnerabilities have made Windows and the Office word-processing and spreadsheet program favored hacker targets. If Microsoft wrote better software, critics say, the problem would largely go away. The prospect of Microsoft making money from



THE VIRUS ATTACKERS

How Microsoft's potential rivals stack up in the \$2.2 billion antivirus-software market

COMPANY	SHARE
SYMANTEC	36%
NETWORK ASSOCIATES	24
TREND MICRO	14
COMPUTER ASSOCIATES	5
SOPHOS	3
OTHER	18

Data: IDC

its own shortcomings has prompted some cynical chatter in the industry. "The fear is of the fox guarding the henhouse," says Bruce Schneier, chief technology officer at Counterpane Internet Security Inc.

What's behind the move? It's not the money: The \$2.2 billion antivirus business is chicken feed to a company that last year generated \$32.2 billion in revenues. But Microsoft badly wants to protect its virus-battered reputation. It could do so by convincing users to take advantage of antivirus software and regularly download its patches. According to Microsoft research, 63% of home PC users either don't have antivirus software or

are using obsolete programs. "My focus is on the people who aren't currently protected," says Mike Nash, vice-president of Microsoft's security business unit.

Microsoft is providing few specifics about its antivirus strategy. But analysts expect it to follow the existing industry model: selling subscriptions to service allowing consumers to update

their antivirus protection against new strains of malicious code that emerge. "That's certainly the thinking we have," says Nash.

Of course, rivals won't have over the consumer market without a fight. But they're sufficiently realistic to know that their best bet lies in the corporate market, where Microsoft will pose less of a threat. Corporate servers often run non-Windows operating systems, and Microsoft has no plans to make its security software work with rival products. What's more, many corporate buyers are leery of Microsoft's engineering. "The general response in the corporate world is no one trusts Microsoft security," says Geri Munster, senior research analyst at U.S. Bancorp Piper Jaffray.

In the consumer market, by contrast, software that's easiest to use, even if it isn't technically the best, tends to win out. And since Microsoft's products probably will be bundled into Windows, it will have a big advantage. Few believe that including antivirus software in Windows will violate antitrust laws. What potential rivals fear is that Microsoft will use its market power to thwart them. "The question is, will they play fairly or will they abuse their monopoly position?" asks Symantec CEO John W. Thompson.

He and other rivals know they are facing a force more ominous than any virus. "When Microsoft enters an industry and includes the software in Windows, the sector disappears," says Steve Chang, CEO of antivirus software maker Trend Micro Inc. It's a lesson the software industry knows all too well.

By Jay Greene in Seattle, with Jim Kerstetter in San Mateo, Calif., and Steve Hamm in New York

Since Microsoft's products probably will be bundled into Windows, the software giant will have a big advantage

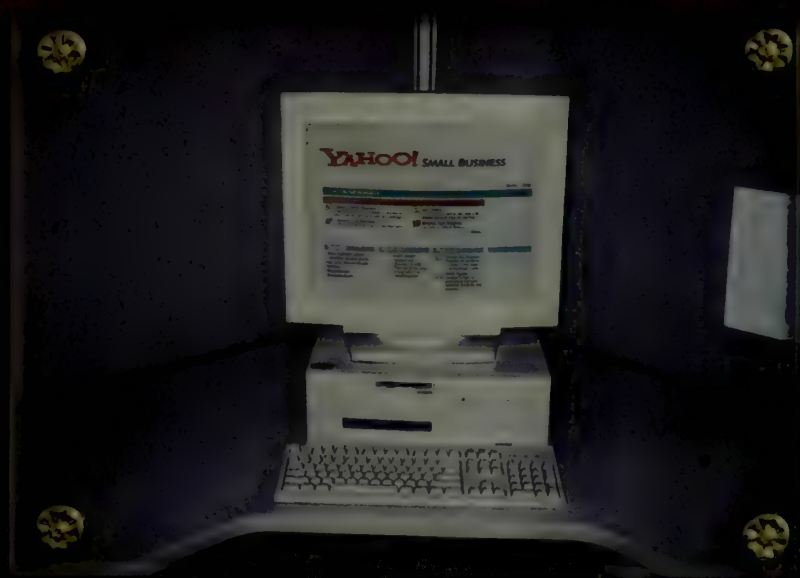
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- create an online store
- go to yahoo.com, click small business

EMPLOYEE OF THE MONTH



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Small Business

EDITED BY MONICA ROMAN

THE UPS AND DOWNS OF BIG TOBACCO

TOBACCO COMPANIES HAVE recently been battling on two fronts: smoker lawsuits and discount competition. On Sept. 16, the industry had a victory on one but suffered a loss on the other the next day. Good news came from the Illinois Supreme Court, which ruled that Altria Group's U.S. tobacco division could post a \$6.8 billion bond in a class action, instead of \$12.1 billion. That drove shares of the Marlboro maker up 10.4%, to \$44.65. The court also agreed to the company's request that it review that loss. Analysts now expect an accelerated resolution of the class action. But the next morning, bad news came from Altria rival R.J. Reynolds Tobacco. Citing a drop in both volume and margins, the maker of Camels and Winstons announced it would cut 40% of its workforce. The move will

eliminate 2,600 jobs and carry \$425 million in earnings charges. Investors greeted the news by bidding up RJR shares 13.7%, to \$38.86.

ENRON'S BANKERS FEEL THE HEAT

WHAT DID ENRON'S BANKERS know? Plenty, according to the Justice Dept. On Sept. 17, Justice indicted three Merrill Lynch execs for their alleged role in Enron's accounting shenanigans. At issue is a 1999 deal in which Merrill's bankers helped Enron boost profits by temporarily buying several power barges from the Houston energy trader. The Merrill executives, who are the first Wall Streeters to be indicted in the Enron scandal, pleaded not guilty. In an unusual deal, Merrill agreed to establish a panel of executives to approve all complex transactions conducted by its clients, hire an outside auditor, and retain an attorney—hand-picked by Justice—to keep tabs on that auditor's work.

CLOSING BELL

INSECURITY

Accounting scandals and terrorism should be a windfall for Kroll, which specializes in reducing corporate risk. But no one said there wouldn't be bumps along the way. Investors knocked 13% off Kroll shares, to \$21.80, on Sept. 17, after it said it would miss its annual forecast because of a restructuring charge.



INDIGESTION AT KRISPY KREME

IN THE PAST TWO YEARS, Krispy Kreme Doughnuts' earnings have been sweeter than one of its glazed doughnuts. But suddenly sales aren't looking so delectable. Although operating earnings have averaged 63% quarterly growth over the past 10 quarters, overall average weekly stores sales were down 1.1% in the fiscal second quarter. "New unit productivity will continue to be a drag on systemwide average weekly sales," says John Ivankoe, a J.P. Morgan Securities analyst who recently downgraded the stock to "underweight." As for Winston-Salem (N.C.)-based Krispy Kreme, it insists results will keep rising in the double digits.

HEADLINER: JEFFREY IMMELT

SHOW THEM THE MONEY

Jeffrey Immelt has even more reason to care about cash flow than he did before. In another sign that Corporate America's love affair with stock options is on the wane, the General Electric chief has a new equity package that will grant him stock only if the company's cash flow from operations rises at least 10% annually over the next five years.

The other half of the so-called performance share units, which are currently valued at \$7.5 million, will go to him if GE stock meets or exceeds the performance of the Standard & Poor's 500-stock index over the

same period. The deal replaces stock options, which GE is now expensing. Last year, Immelt got 1 million stock options, which vest in equal parts over five years.



GE also has changed the equity packages of several hundred other GE execs to give them a mix of options and restricted stock, rather than just options. For a company that has handed out options to more than 45,000 employees since 1989, it's a significant shift. But faced with the likelihood of having to expense options in the future, more companies may follow GE's lead.

Diane Brady

LOCKHEED: ANOTHER INFO TECH BET

LOCKHEED MARTIN CONTINUED the defense industry's flight toward information technology with its Sept. 15 deal to buy San Diego-based Titan for \$2.4 billion. The Bethesda (Md.) company, the world's largest defense contractor, is buying a unit that could expand the intelligence, communications, and computer services it can offer the Pentagon. In August, Lockheed Martin agreed to buy much of the federal computer business of Dallas-based Affiliated Computer Services.

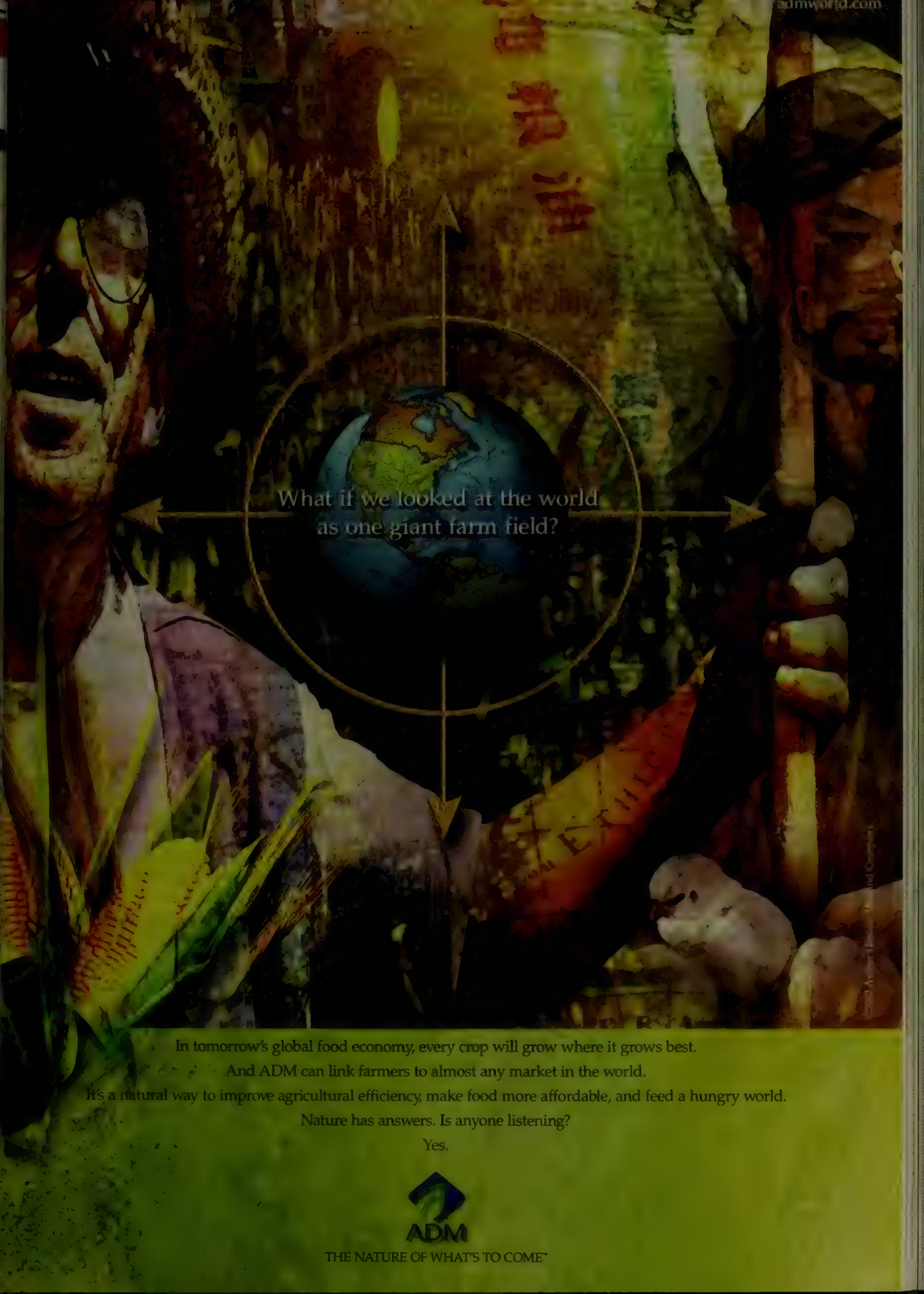
A SENATE REBUKE FOR THE FCC'S CHIEF

THE SENATE DEALT FEDERAL Communications Commission Chairman Michael Powell another blow. On Sept. 16, the legislative body voted 55-40 to veto sweeping new rules

passed by the FCC just three months ago to allow greater media consolidation. The vote is likely to be only a symbolic victory, however, because it falls short of the two-third majority needed to block a veto threatened by the White House. House Speaker J. Dennis Hastert (R-Ill.) has also vowed to block any companion resolution from reaching a vote in the House of Representatives. Still, he could be overruled if 218 House members request such a vote.

ET CETERA...

- United Airlines parent UAL will launch a low-fare carrier next February.
- Boston Scientific revealed data showing its new drug-coated stent works as well as Johnson & Johnson's.
- Sears acquired the Structure men's brand from Limited Brands.



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EDITED BY RICHARD S. DUNHAM

MEDICARE REFORM: AS REALITY SETS IN, A NEW PLAN EMERGES

When the House and Senate passed separate versions of Medicare reform last spring, many Hill-watchers predicted a quick bill-signing in the Rose Garden. After all, the Republicans who run Washington wanted to prove they could deliver on their promise to give elderly voters a new prescription-drug benefit. But exploding deficits and bitter ideological disputes are threatening ambitious reform efforts. Now, the chances of Bush seeing a major Medicare restructuring are down to 50-50. And in an effort to build bipartisan consensus out of partisan gridlock, a surprising coalition is mulling a stripped-down drug benefit dubbed Plan B. Says Senator Chuck Hagel (R-Neb.): "The forces of reality have set in."

Thirteen GOP House conservatives, who oppose a big new entitlement and worry about its \$400 billion-plus price tag, are asking their leadership to consider a far less ambitious proposal. And Senate Republicans such as Hagel, John Ensign (Nev.), and Don Nickles (Okla.) are looking at ways to target benefits to those with low incomes or high drug bills.

Similarly, more than 40 moderate House Democrats, led by California's Cal Dooley, are pushing their own scaled-back plan. In the Senate, Democrats including New York's Hillary Rodham Clinton are exploring compromises. And some liberal groups could back the deal if a broader bill collapses. "Even with \$400 billion, you can't have a [full] benefit," says Ron Pollack, executive director of Washington-based advocacy group Families USA. "You have to make choices. The first call should be those who have the greatest need."

The still-evolving plan would ditch the new drug premium, complex benefits, and controversial reforms of the broad-based bill. Instead, Washington would issue a free discount drug card to all those 65 and older that could cut prices by

10% to 20%. The poorest seniors could still get benefits through Medicaid. The feds would pick up roughly the first \$1,000 of drug costs for those making up to, say, \$20,000. And all retirees with catastrophic expenses—regardless of income—would get extra help. The bill would also boost government reimbursements for doctors, rural hospitals, and other health providers—a key to wooing wavering lawmakers.

The compromise would avoid the nastiest issues in the reform debate. For instance, many Republicans won't vote for

restructuring Medicare unless it includes a central role for private insurance. But most Democrats, and some GOP moderates, won't support a measure that includes such a provision, fearing it would destroy the traditional program. A bare-bones compromise would delay the insurance battle until after 2004. "We could get this bizarre meeting of the minds," says one health lobbyist. "If they can't resolve these issues, Plan B becomes a lot more credible."

That's not to say it's a sure shot. Backers must agree on how much to spend and how to divide the money between a catastrophic benefit and a low-income subsidy. And for now, the combatants aren't ready to abandon broader reform. The powerful seniors' lobby AARP hasn't given up on benefits for all. Bush and the Hill GOP leadership continue to push for a big Medicare overhaul. And liberals, led by

Senator Edward M. Kennedy (D-Mass.), still want the most generous benefits possible.

Hill Republicans say it's unlikely an ambitious reform plan can succeed unless Bush devotes substantial time and political capital to the cause. But the President is busy with foreign-policy flare-ups and a vexing economy. With little progress so far and lawmakers eager to deliver an antidote to the high cost of drugs, Plan B could soon emerge as Plan A.

By Howard Gleckman



HAGEL: A bare-bones answer

CAPITAL WRAPUP

THE SEC VS. GEOS

The Securities & Exchange Commission is ready to give corporate boards a dose of democracy. *BusinessWeek* has learned that the SEC is putting the finishing touches on proposals to make it easier for shareholders to nominate their own candidates for board seats on the official proxy ballot. Despite stiff opposition from Corporate America, the SEC is likely to give the proposals tentative approval in early October.

In July, the SEC suggested it would consider a two-stage process for get-

ting outside nominees on the proxy. In the detailed plan, shareholders would first need to show that management and the board weren't responding to owners. The "triggering event" could be a majority vote on a shareholder resolution requesting access to the proxy ballot. Another trigger could be the company's failure to act on shareholder proposals that win majority votes and whose sponsors hold at least 1% of the outfit's equity.

Once either of those hurdles is cleared, shareholders could nominate candidates for at least two seats. The

SEC may let them put up to 20% of director slots in play. To avoid chaotic contests, investors would have to agree on nominees. If they can't, the group representing the most shareholders would get to pick the insurgent slate. "We don't want to turn [this] into California," says a top official. CEOs fear that giving shareholders access to the proxy will crimp their agendas. But with the four SEC commissioners likely to support Chairman William H. Donaldson, final rules could be in place for 2004's proxy season.

By Amy Borrus

STALLED

Is the DaimlerChrysler deal a mistake? Many say yes—and call for Schrempp's head



On a brisk September evening DaimlerChrysler executives gather for a party at a sprawling Mercedes-Benz dealership in Frankfurt. As guests sip champagne and nibble crudités, the auditorium lights dim, music swells, and a huge video screen displays a young Formula One driver filmed the morning in Brescia, Italy. He slips the 626-horsepower engine of the new Mercedes-Benz \$416,000 SLR McLaren sports car into gear and tears into the Alps, retracing part of the historic Mille Miglia (1,000 mile) road race.

Milling among the crowd is Chrysler Group Chief Executive Dieter Zetsche. The German boss dispatched three years ago to turn around the company's troubled U.S. unit. The breathless celebration of Mercedes' muscular engines, prestigious sedans, and leading-edge technology is a far cry from Zetsche's daily struggle in Auburn Hills, Mich. For if Mercedes is the profit engine behind DaimlerChrysler's \$166 billion, globe-spanning business, Chrysler remains its dragging mule. Its unpopular models, inefficient factories, and weak brand image have defied efforts of the new boss for a quick turnaround. Says Zetsche: "We have to deal with the hand we have, and turn it into a winning hand."

Still, there's no masking the stark reality behind the biggest industrial merger in history. Five years after Daimler-Benz CEO Jürgen E. Schrempp carried out a \$36 billion fusion with Chrysler Corp., his promise of creating the world's most profitable carmaker is a financial blowout. After an unexpected \$1 billion loss in the second quarter, Chrysler may end 2003 in the red, despite Schrempp's boast a year ago that the unit would

WORRIED: Now, Schrempp gives few interviews

ern \$2 billion this year. That wipes out the gains of 2002 and follows on the heels of the \$5.8 billion loss in 2001.

Chrysler is not the only thing Schrempp, 59, is worrying about these days. In July, a J.D. Power & Associates Inc. survey revealed embarrassing quality deficiencies at Mercedes itself, raising questions about whether the drain on management from Chrysler is affecting the classiest of German marques. Mitsubishi Motor Corp., another troubled imperial possession, has warned of a \$683 million first-half loss and has slashed its full-year earnings forecast by 75%, as U.S. sales plunge. In July, Daimler's \$30 billion truck business embarked on a sweeping reorganization to reap savings from sharing parts and pooling purchasing for its various units after losing \$960 million in two years. And in August, Daimler agreed to pay \$300 million to settle a lawsuit by institutional investors and still faces a \$2 billion claim by shareholder Kirk Kerkorian.

Was the merger a colossal mistake? A growing chorus of voices says it was. Many experts think Chrysler, whose com-

Sharp cost-cutting at home has led to quality gripes on Mercedes models

petitiveness Schrempp badly misjudged in 1998, might have gone bankrupt by now without its German parent. Schrempp promised a swift integration and a world-spanning company that would dominate the industry. But five years later, new products have failed to pull Chrysler out of a rut. And DaimlerChrysler dominates only where it did before—in luxury cars. It now owns or controls struggling players in both the U.S. and Asia. Analysts even speculate that DaimlerChrysler might jettison Chrysler altogether. The CEO refuses to admit defeat. "There are one or two things we didn't do right [at Chrysler] in the beginning. But we will get it right," a subdued Schrempp told

journalists at the Frankfurt motor show.

Many institutional investors and small shareholders are fed up. They want to see Schrempp replaced and the deal unwound. The market capitalization of DaimlerChrysler, at \$38 billion, is well below the German auto maker's \$47 billion market cap before its marriage to Chrysler. BMW, the company closest in size and market segment to Mercedes, has seen its market value rise by 27%, to \$26 billion, since the end of 1998.

But the most stinging criticism comes from those within the vaunted 119-year-old auto maker, who point to top management error, not market woes, for the company's dismal performance. "The entire management board is too removed from the business. Things have been going in the wrong direction for a long period of time," says one senior DaimlerChrysler manager.

Poor execution isn't the only problem. The logic behind Schrempp's vision of *Welt AG*, a world auto company with integrated parts, looks increasingly flawed. Sure, Chrysler and Mitsubishi may be able to cut their costs by sharing parts and engineering. But many auto-industry experts and top executives agree that Schrempp erred fundamentally in merging a luxury auto maker with a mass-market brand—an unnatural combination that offers limited benefits and requires twice the expertise and effort to manage. Moreover, luxury has proved a better source of growth and profits than mass-market cars.

True, when Mercedes management sets its mind to change, it can be very successful. In the early '90s when Mercedes was losing ground to the Japanese, it revamped models and invested in new market niches and factories.

But the global auto market today is brutally competitive. Car sales in Asia, Europe, and the U.S. are all in a long slump, and the Japanese continue to seize market share from Chrysler. The toughest challenge may be the relentless downward pressure on prices in the U.S. Big Three rebates now average nearly \$4,000 per vehicle, more than double 1998 levels. That makes it hard to earn a premium on even the newest, snazziest models. Witness Chrysler's \$38,000 2004 Pacifica minivan-SUV crossover. Consumers considered the

price tag steep for a Chrysler, and it now comes with a \$1,000 rebate. In August, Chrysler lost to Toyota its 53-year position as America's No. 3 carmaker. "Chrysler could prove impossible to fix," says Garel Rhys, professor of automotive economics at



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DAIMLERCHRYSLER'S WOES

MOUNTING LOSSES

Chrysler Group lost \$1 billion in the second quarter, and a long-awaited turnaround is still not in sight. The launch of the upscale Pacifica has been disappointing.

QUALITY PROBLEMS

Mercedes' reputation for top quality is being tarnished by the use of cheaper parts and a recent rash of technical glitches.

REBATE WARS

Profit-draining incentive wars in the U.S. show no sign of abating. Traditionally, incentives are used to clear out inventories before new models hit the showrooms. But Chrysler is already offering \$3,000 back on the 2004 Jeep Grand Cherokee. Chrysler's marketing costs in the

second quarter soared to 29% of sales because of incentives.

OLD FACTORIES

New Japanese factories in the U.S. are more flexible and more efficient than Chrysler's plants and will add to an overcapacity of cars and light trucks. One of the least flexible is the Dodge Neon plant in Belvidere, Ill.

TURNAROUND STALLED

Mitsubishi lost \$683 million in the first half of this year. Synergies in mass-market cars developed with Chrysler will take three to four years to materialize.

**CHRYSLER
PACIFICA**



Data: BusinessWeek

Cardiff Business School in Wales.

The Germans who are doing the driving at Mercedes and Chrysler still counsel patience. They insist that the integration of process know-how and parts sharing is just starting to kick in and that, over time, productivity gains will reduce costs while quality improvements and new models boost Chrysler. But Chrysler's problems are overwhelming the gains. The new products vital to a Chrysler rebound have been slow in coming. The first joint Chrysler-Mercedes engineering product—the sleek Chrysler Crossfire roadster—only recently hit the market. While the \$35,000 car offers German engineering finesse and quality at a bargain, thanks to borrowing 40% of its components from Mercedes, the experiment is a one-of-a-kind. Future Chrysler cars will share most with Mitsubishi, not Mercedes, in order to avoid diluting the luxury German brand image.

In Stuttgart, the fear and loathing of Chrysler is palpable. "Chrysler is the downfall of Mercedes-Benz. It is a hole for billions of euros," says one Mercedes dealer. For the first half, DaimlerChrysler's revenues fell by 11%, to \$75 billion, and net profit declined by 81%, to \$773 million.

For now, Jürgen Hubbert, the respected boss of Mercedes Car Group, has kept Mercedes pumping out steady profits. But there are signs that could portend an erosion of competitiveness. The C-Class compact sedan is straining under competition from BMW's older 3 Series model, while less expensive cars that were developed to spur growth, including the A-Class, are unprofitable. Worse, Mercedes recently suffered a spate of quality problems, including faulty transmissions. J.D. Power's July report on customer satisfaction flagged a number of quality problems on three Mercedes models from the year 2000: the E-Class sedan, the M-Class SUV, and the CLK coupe.

How much more bad news can Schrempp survive? His fate—and that of DaimlerChrysler—depend on Deutsche Bank, DaimlerChrysler's largest shareholder, which has seen the value of its 12% stake plunge by more than \$15 billion since the merger. "The key question is:

What does Deutsche Bank think? Do you throw good money after bad, or cut your losses," says David E. Cole, president of the Center for Automotive Studies in Ann Arbor, Mich. Deutsche Chairman Josef Ackermann says he wants to sell the bank's stake, but not at today's price. The bank is still backing Schrempp, but if Chrysler posts huge losses in the quar-

Pros say Schrempp erred badly in merging luxury and mass-market cars

ters ahead that push the mother company into the red, Ackermann could oust Schrempp.

Dissatisfaction with the merger is growing within Daimler Benz, especially among Mercedes executives. Says one insider: "The race is on to be [Schrempp's] successor." The front-runners: Zetsche and Eckhard Cordes, head

of commercial vehicles who edged the struggling division into the black in the second quarter, even though its margins are still way below target.

Getting rid of Chrysler could be tougher than firing Schrempp. A parent company can put a subsidiary into Chapter 11 bankruptcy and shrug off its pension and health-care obligations. But the works in this case only if Chrysler's obligations aren't guaranteed by parent DaimlerChrysler. Otherwise, creditors and unions would simply take their demands to the parent.

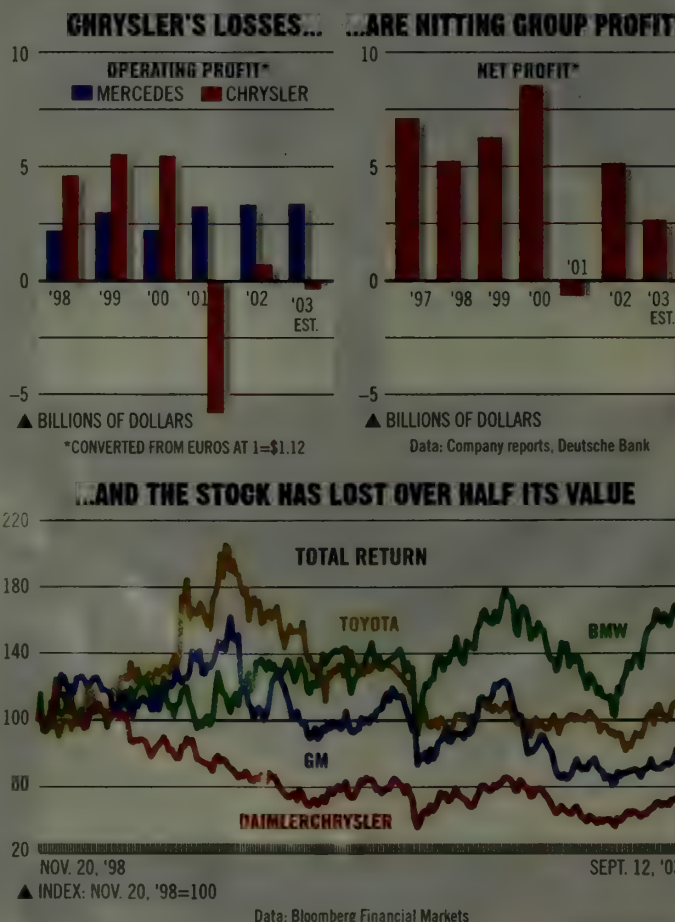
A more likely outcome: Daimler could spin off Chrysler to its shareholders. The question is whether Chrysler's research and development, engineering, and leadership could be disentangled from Daimler's. Daimler might also sell Chrysler pieces, as BMW did with its money-losing Rover unit. Daimler, the theory goes, could sell off Chrysler's profitable Jeep SUV and Dodge truck units for a profit and hand off the money-losing passenger-car business to diehard Chrysler loyalists for \$1. That, however, would surely trigger massive political and labor reactions as thousands of car-unit jobs were destroyed, and benefits jeopardized. Should that, DaimlerChrysler could merge

Chrysler and Mitsubishi car operations into a single unit.

Deutsche Bank will probably keep Schrempp at the helm for now, barring another dramatic setback at Chrysler. But DaimlerChrysler executives concede that a real turnaround will take three to five years and billions in investment. In short: a new generation of cars built in updated plants. Zetsche and Schrempp are confident they can pull that off. But many argue that Schrempp, who quadrupled his salary after the merger and ranks in compensation review as Germany's top-paid CEO with an estimated \$12.1 million pay package in 2002, does not deserve a third chance. If he fails again, Chrysler's problems will overwhelm its German parent in less than five years, warns an insider. "It will be the biggest industrial cleanup job Germany has ever seen." Given Schrempp's checkered track record, that's a high-stakes gamble.

By Gail Edmondson in Stuttgart and Kathleen Kerwin in Auburn Hills, Mich., with bureau reports

DAIMLERCHRYSLER: THE MISBEGOTTEN MERGER?



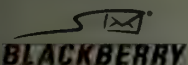


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DIPLOMAT

Badawi (right) is known as a consensus-builder, a skill he learned in his eight years as Foreign Minister



MALAYSIA

MALAYSIA AFTER MAHATHIR

A new economic model is needed. Can Badawi provide it?

Late next month, a low-key ceremony will take place on the fourth floor of a pastel-pink palace in the new Malaysian capital of Putrajaya. In the privacy of his inner chambers, Prime Minister Mahathir Mohamad is to hand over his so-called job manual—a largely symbolic binder of documents—to Abdullah Badawi, his Deputy Prime Minister. Sporting the long-sleeved safari suits the two wear around

the building on any weekday, they will shake hands and say their goodbyes. Then Mahathir will stroll across the marble floor, place his thumb on the biomechanical security lock on the front door, and leave Malaysia in the care of its first new Prime Minister in 22 years. “I will be nothing,” Mahathir has told the Malaysian press. “I will be Dr. Mahathir Mohamad.”

Can a man who has ruled with an

authoritarian hand for more than two decades truly be expected to walk away from the corridors of power? Some find it hard to believe that a leader as forceful as the 77-year-old “Dr. M” would step down so quietly, but many in Kuala Lumpur say the transition has already effectively happened. Since Mahathir, a former physician, tearfully announced in June, 2002, that he wanted to quit, he has been slowly handing his duties to Badawi. Indeed, last spring Mahathir took a two-month vacation, leaving his deputy in charge as the SARS outbreak pummeled tourism and the war in Iraq brought angry Malays into the streets. Badawi’s diplomatically phrased objection to the Iraq war offended no one in the international community while appeasing protesters and

showing that the heir apparent possessed a deft touch. “They are as much my people as they are Dr. Mahathir’s,” Badawi told a U.S. official in August.

In his long tenure, Mahathir clearly healed much of what ailed Malaysia. When he rose to power in 1981, the country still bore scars from violent race riots and a long fight against a stubborn communist insurgency. Since then, it has become a model of prosperity, civil order, and economic growth for Asia. “Mahathir created a nation,” says Robert Broadfoot, managing director of Political & Economic Risk Consultancy in Hong Kong. “There’s real pride in the country.”

Along the way, though, Malaysia developed a cozy, inbred business and political culture that critics hope the new Prime Minister will change. Badawi is showing signs that he may do so. But he’s a card-carrying member of the Establishment, too. “To consolidate his power base, he needs to play the game,” says Bridget Welsh, a Malaysia expert

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at the Paul H. Nitze School of Advanced International Studies in Washington. "But he needs to tackle the rules of the game. That's the dilemma."

There's little doubt that Badawi will present a far different public face to the world. Mahathir has earned a reputation both as a fierce defender of Asia against the West and as a tough political infighter at home. He may be best remembered by many Westerners for his fierce anti-American outbursts and anti-Semitic statements. In contrast, the 63-year-old Badawi is known as a consensus-builder, a skill he learned in his eight years as Foreign Minister. He is also the son and grandson of Islamic scholars and a student of Islam himself, earning him the respect of Malaysia's new breed of fundamentalist Muslims, a growing political force. "Badawi will have stronger Islamic credentials than Mahathir, so he'll be able to tone down his rhetoric," says a U.S. defense official who met Badawi recently.

Badawi declined to be interviewed for this story. Mahathir, after receiving a letter from *BusinessWeek* asking for comment on charges by critics that his regime had been tainted by cronyism and corruption, told reporters in Kuala Lumpur that any such allegations were "nonsense."

As Malaysia prepares for the handover to Badawi, the country is feeling upbeat about its future. The stock exchange has jumped nearly 20% since January, and the economy is expected to hit 4.5% growth this year. Foreign investors have long liked the political stability, good infrastructure, and relatively cheap skilled labor Malaysia offers. In exchange, foreigners have agreed to honor laws that often require them to give equity stakes in their enterprises to Bumiputras—a local term for ethnic Malay Muslims.

This arrangement frequently drew charges from critics that Malaysia Inc. benefited from state largesse and that it tolerated corruption. Until recent years,

Meet the New Boss

Badawi's style is far different from the authoritarian Mahathir's



BADAWI

- Advocates better corporate governance and is speaking out against graft
- Is an Islamic scholar and has good relations with Malaysia's increasingly radical clerics
- Has shown diplomatic tact in handling explosive issues such as the war in Iraq
- Is known as a patient, nonconfrontational negotiator with few enemies
- Is expected to slow the pace of infrastructure development



MAHATHIR

- Transformed Malaysia into a prosperous nation, but one that has tolerated corruption
- Defused ethnic tensions with an affirmative-action program promoting Malays
- Has offended the West with his fierce anti-American and anti-Semitic statements
- Is known for fighting political battles to the bitter end, even if it alienates voters
- Has spent billions on infrastructure projects such as a new capital

as long as the factories were humming, few were concerned. Today, though, investors can avoid Malaysia's intricate corporate dance by building their factories in other countries—China first and foremost—that offer cheaper skilled labor and good infrastructure, too. Average factory wages in Malaysia are \$159 per month, compared with \$125 in Chi-

na and just \$18 in Vietnam. "Malaysia is being sandwiched lower-cost producers such as China, India, and Vietnam," says Rajeev Malik, a senior economist at J.P. Morgan Chase & Co. Singapore. "But it's unable to move up the value chain and compete with Korea, Taiwan, Singapore."

To make Malaysia more attractive to foreign investors, Badawi seems ready to shake up the country's business culture. For months now, he has been breaking protocol by railing against corruption at otherwise polite, white-tablecloth luncheons with Malaysia's upper crust. "We cannot dismiss the problem by saying that this is just the way things are done in Malaysia and offer to pay a bribe," he told Malay graduates of elite British universities in a speech on March 6. He has also vowed to "rectify the 'excruciating' level of red tape at government agencies that regulate hotel management and land transactions."

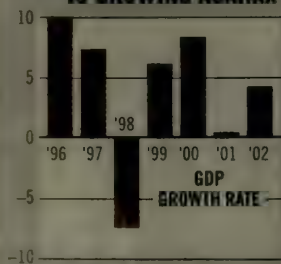
Badawi may also rein in outlays for the giant public-work programs that have been Mahathir's signature. Since 1990, Malaysia has spent well over \$1 billion on infrastructure projects such as the Kuala Lumpur International Airport, a new capital in Putrajaya, and the Petronas Twin Towers in Kuala Lumpur, the world's tallest buildings. In the March address, Badawi said

that some such projects have "become too embarrassing to mention."

There's little doubt that the handover of power will initially be smooth. But Badawi will come under enormous pressure to prove himself quickly in the political arena. One of his first challenges will be to ensure victory for his party in elections expected next spring. "If he does well, he can come up with his own policies, programs, and agenda," says a prominent Malaysian economist. "Only after the elections can he prove he's not living under Mahathir's shadow." When that happens, though, the answers to Badawi's real challenges—remaking the business culture, reorienting the economy—surely won't be found in the job manual that Mahathir will leave in his hands. Only when Badawi becomes his own man will the world know if he is up to the task of taking over where the good doctor left off.

By Michael Shari in Kuala Lumpur

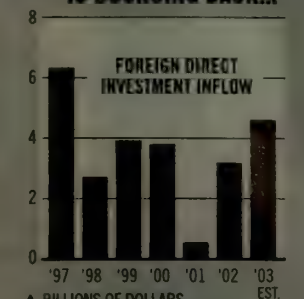
MALAYSIA'S ECONOMY IS GROWING AGAIN...



▲ PERCENT

Data: Malaysian Finance Ministry, Malaysian Institute for Economic Research

...AND FOREIGN INVESTMENT IS BOUNCING BACK...



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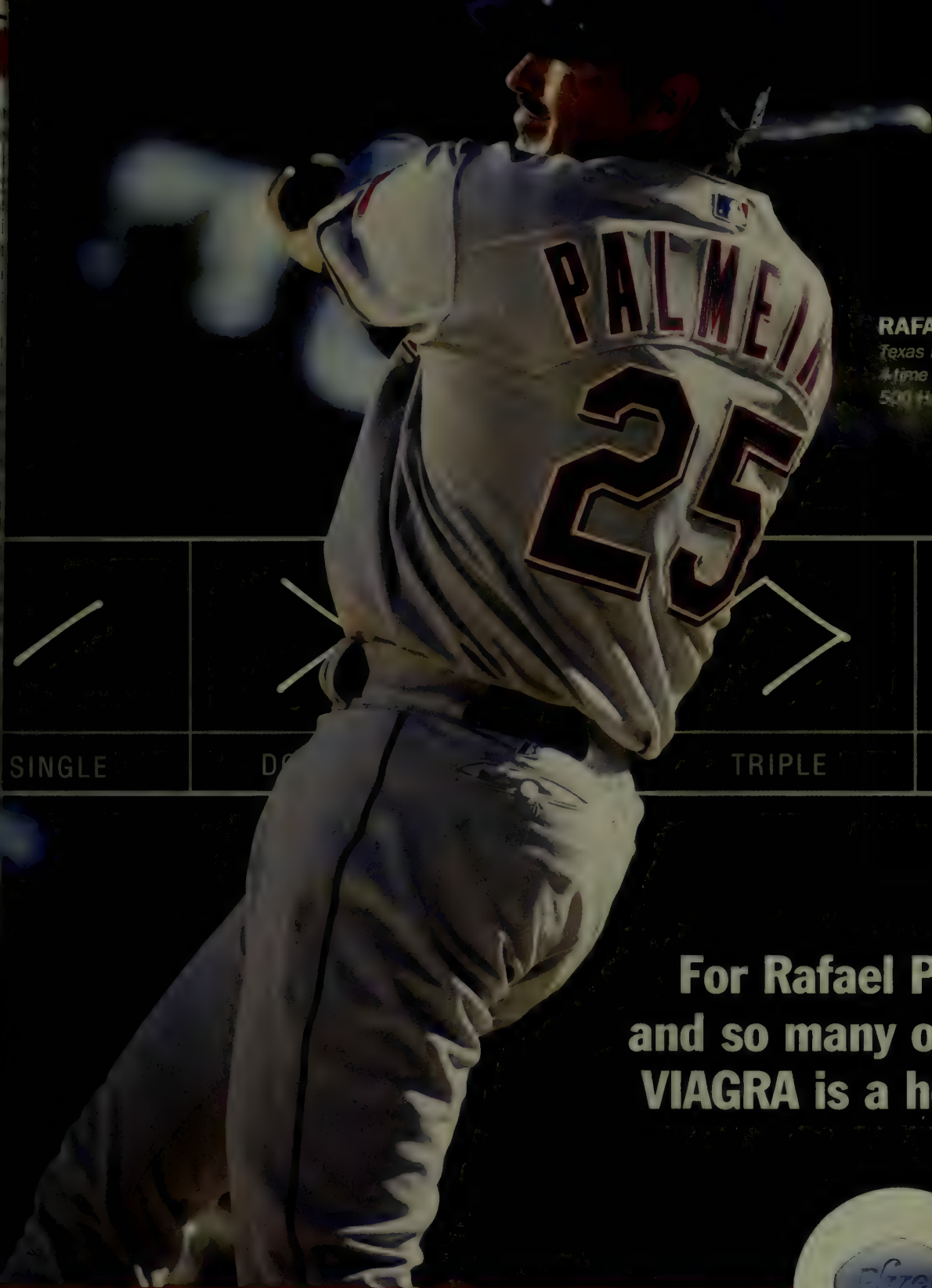
Data: U.N. Conference on Trade and Development, Bank Negara Malaysia

...BUT IT'S GETTING PRICED OUT OF THE MARKET



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Data: International Labor Organization, Boston Consulting, government reports



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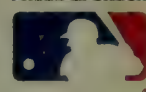
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When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

How VIAGRA Works

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

VIAGRA Is Not for Everyone

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates—either regularly or as needed—you should never take VIAGRA. If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children, or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

What VIAGRA Does Not Do

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV—the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

What To Tell Your Doctor Before You Begin VIAGRA

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you:

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, heart attack or narrowing of the aortic valve)
- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems

- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

VIAGRA and Other Medicines

Some medicines can change the way VIAGRA works. Tell your doctor about any medicines you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies.

- Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*).
- If you are taking alpha-blocker therapy for the treatment of high blood pressure or prostate problems, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as you take your dose of alpha-blocker.
- If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*).
- VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

Finding the Right Dose for You

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period. If you are taking alpha-blocker therapy, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as your dose of alpha-blocker.

How To Take VIAGRA

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

Possible Side Effects

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

Accidental Overdose

In case of accidental overdose, call your doctor right away.

Storing VIAGRA

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at 25°C (77°F); excursions permitted to 15-30°C (59-86°F) [see USP Controlled Room Temperature].

For More Information on VIAGRA

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com, or call 1-888-4VIAGRA. 23-5515-00-6 Rev. 6 Sept. 2002

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SWEDEN

THE EURO: HOW DAMAGING A HIT?

Sweden's "no" vote may alter the path of EU integration

Two days after Swedish voters decisively rejected the euro, Rune Andersson, one of the few business leaders in the "no" camp, savored what may prove to be a landmark victory. This is evidence of the Swedish people's common sense and independence," said the Electrolux Chairman. "We had a fraction of the yes side's resources and few political heavyweights."

The 14-point margin of victory for the no's confounded the pollsters and left Swedish politics in tatters. It also sent shock waves across Europe. Swedish Prime Minister Göran Persson, who stacked loads of political capital on adoption of the European single currency, now finds himself in his worst political crisis since he took office in 1996. The leader of the Social Democrats has lost his most valuable ally and apparent successor, Foreign Minister Anna Lindh, who was fatally stabbed four days before the vote. And the centerpiece of his economic strategy—boosting trade and investment by inserting Sweden firmly into the European Union—looks unattainable for years. "There will have to be a tremendous change in the political and economic circumstances" before the country's leadership can contemplate another euro referendum, says Klas Eklund, chief economist at Stockholm bank SEB.

The Swedish vote also sent an unwelcome message to Europe's leaders. Even

as officials in Brussels are putting the final touches on a draft European constitution, the Swedish *nej* signaled that fissures within the 15 member European Union are likely to persist and even intensify. No-campaigners in the other euro holdouts, Britain and Denmark, have gotten a boost. While some think the Swedish vote will slow the pace of European integration, others think the reverse will happen. "The Germans and French may now go ahead and do what they want without consulting the less reliable Europeans," says Katinka Barysch, chief economist at the Center for European Reform, a London think tank.

Indeed, Sweden's rejection of the euro may be a sign that the European integration train is breaking up into different segments. Core players such as Germany and France will continue to drive the process, even as they feel free to flout some of the EU's rules. Then there are the 10 countries from Eastern Europe, the Baltics, and the Mediterranean, which are

REJECTION Stockholm voters cast ballots on the single currency

scheduled to join the EU next May and are ecstatic about being admitted to the club. It's no small irony that

on the day Swedes snubbed the euro, Estonians voted overwhelmingly to join the EU. Bringing up the rear are outliers such as Britain and Sweden, where many are wary of giving up control of economic and social policies.

Resistance to integration could widen beyond the single currency. Unless Europe's political bosses do a better job of selling the benefits of their project, they may hit speed bumps in getting their constitution ratified. They already face potentially damaging plebiscites in Ireland and Denmark, whose laws mandate that the new blueprint must be put to a vote. And Britons are pressing Prime Minister Tony Blair to do the same. Although he's an avowed europhile, Blair looks unlikely to chance a referendum on the euro for at least three years. The Swedish vote was "a shot across the bow here," says Michael Hughes, chief investment officer at Baring Asset Management in London.

German and French politicians seem likely to shrug off the Swedish result as a protest from a small country that has long shunned alliances, such as NATO. But Berlin and Paris have themselves to blame for some of the EU's poor image. Both have defied the requirement that euro zone members keep their budget deficits below 3% of gross domestic product. Officials in Sweden and Holland, both of which have followed the rules, have decried such high-handedness.

All this fractiousness contributed to Swedish voters' judgment that adopting the single currency at this stage was an unnecessary risk. After all, the country is running a budget surplus, and gross domestic product growth is headed for 1.5% this year, well above the 12-member euro zone's 0.5%. And what of predictions that companies will now abandon Sweden? That's "empty talk," says Doris Olson, a 76-year-old retired librarian. In coming years, Olson and her compatriots will learn if there will be a price to pay for their vaunted independence.

By Stanley Reed in London, with Ariane Sains in Stockholm, David Fairclamb in Frankfurt, and Carol Matlack in Paris

EURO HOLDOUTS

*Opposition to Europe's
single currency runs
high in the following
three countries*

NO YES

SWEDEN*

56% 42%

BRITAIN**

51% 35%

DENMARK**

35% 49%

* Sept. 14 referendum

**Aug. survey

Data: Swedish government, Barclays
Capital/NOP, Danske Bank

EDITED BY ROSE BRADY

NOW IRAQ MAY BRING ANKARA AND WASHINGTON TOGETHER

Relations between longtime allies Turkey and the U.S., severely strained as a result of the Iraq conflict, may be set to improve dramatically. Fierce grassroots opposition to the war led the Turkish Parliament to vote on Mar. 1 to refuse U.S. ground troops free passage through Turkish territory—a move that complicated Pentagon war plans on the eve of the Iraq operation. Relations flared further in July when U.S. troops detained 11 Turkish special forces in northern Iraq on suspicion of plotting to murder the Kurdish governor of Kirkuk—a charge Ankara angrily dismissed.

Now, however, both sides have strong strategic motives to repair the relationship. The Bush Administration, eager to shift some of the burden of Iraqi peacekeeping off U.S. and British troops, is keen to have a muscular Turkish military presence in Iraq. For its part, Turkey wants the U.S. to help it disband 5,000 heavily armed Kurdish guerrillas of the anti-Turkish Kurdistan Workers' Party, or PKK, in northern Iraq. The PKK, a separatist movement dedicated to carving out an independent Kurdish nation in southeastern Turkey and surrounding areas, is blamed for a guerrilla war that has left more than 30,000 Kurds and Turks dead since the 1980s.

Ankara is particularly concerned because the PKK on Sept. 1 lifted a cease-fire it had declared in 2000. That truce followed the capture of PKK leader Abdullah Ocalan by Turkish authorities the previous year, an action that led to an easing of security concerns and significant political liberalization. A renewal of PKK attacks, Turkish officials worry, could stop liberalization moves and endanger Turkey's rapprochement with the European Union. That's one reason Ankara is eager to enlist U.S. support in its fight with the PKK.

Publicly, both Washington and Ankara deny any horse-trading. Nevertheless, the request for Turkish troops is like-

ly one reason the White House informed Congress on Sept. 1 that it plans to award Turkey up to \$8.5 billion in loan guarantees. An accord on the guarantees, which would be used to pay down Turkish foreign debt, could be signed by the end of September. Meanwhile, on Sept. 12, Turkish and U.S. officials agreed on a joint plan to combat PKK guerrillas. "All terrorists and safe havens have to be eliminated from Iraq. Period," says an Administration official. Details haven't been disclosed. But Soner Cagaptay, coordinator of the Washington Institute for Near East Policy's Turkish program, says the two sides could work together "to capture the leadership of the PKK," which would "paralyze" the organization. Turkey and the U.S. will also urge guerrillas who aren't part of the PKK leadership to take advantage of a partial amnesty. Soldiers who turn themselves in by February, 2004, earn lenient sentences.

For its part, the government of Recep Tayyip Erdogan, an Islamist conservative who has been Prime Minister since mid-March, is readying plans to send 10,000 peacekeepers to Iraq. They will probably go to Sunni Arab areas near Baghdad rather than to more sensitive Kurdish zones in the north. Turkey's Parliament is expected to approve the deployment even though 64% of the public oppose the move. "Right now we have to be [in Iraq] not for war, but for peace," says Reha Denemec

deputy chairman of the ruling Justice & Development Party. There are other benefits to improved U.S.-Turkey ties. Turkish companies are set to win contracts to help rebuild Iraq's power infrastructure and repair hospitals. And as one of the few real democracies in the Muslim world, Turkey can also serve as a role model. As the U.S. tries to reshape Iraq, that's a good reason to give Turkey a seat at the table.

By John Rossant in Paris, with Louisa Edgerly in Istanbul and Stan Crock in Washington



IN TURKEY: Cooperation

GLOBAL WRAPUP

BUSH-PUTIN SUMMIT

► Vladimir V. Putin's and George W. Bush's meeting at Camp David on Sept. 26 is expected to underscore the resilience of the U.S.-Russian relationship, despite Moscow's opposition to the Iraq war. Sure, Putin shares French and German concerns about the U.S.-led occupation, but he has also been working to find a formula that would bridge the divide in the U.N. Security Council and lead to a peacekeeping mission in Iraq, possibly including Russian troops. On another

thorny issue, Moscow has frozen its support of Iran's nuclear program.

In return, Putin wants stronger U.S. backing for Russia's bid to join the World Trade Organization and the lifting, finally, of the decades-old Jackson-Vanik Amendment, which tied Russia's trade status with the U.S. to its emigration policy. Putin is facing criticism at home for his pro-U.S. tilt.

REGULATORY CLEANUP IN BRAZIL

► In a move likely to please investors, Brazilian Finance Minister Antônio Palocci has promised to streamline

government regulation of newly privatized industries such as telecommunications, power, and oil.

Investors have spent \$80 billion buying privatized Brazilian companies since the mid-1990s. But some got their fingers burned because sales went ahead before regulations were in place. A row erupted earlier this year when the Communications Ministry tried to hold up rises in phone charges agreed to in earlier contracts. "We want to guarantee to investors that contracts will be respected," Palocci told *BusinessWeek* on Sept. 15.



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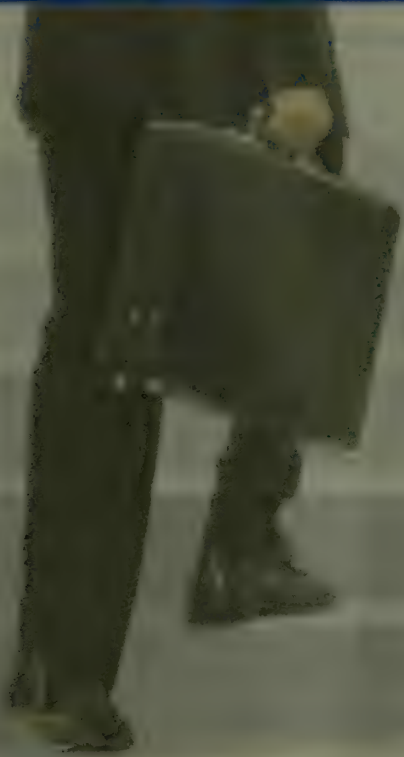
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COMMENTARY

By Mark Hyman

BASEBALL'S PLAYING FIELD GETS EVEN LESS LEVEL

As Bud Selig spoke from his office in Milwaukee, the sweet music of a pennant race crackled over the radio. The Cubs and Cardinals were locked in a tight contest. And Selig, baseball's indomitable commissioner, was savoring every foul ball. "Tie game, terrific game. But the whole season has been close and competitive," cooed the commish.

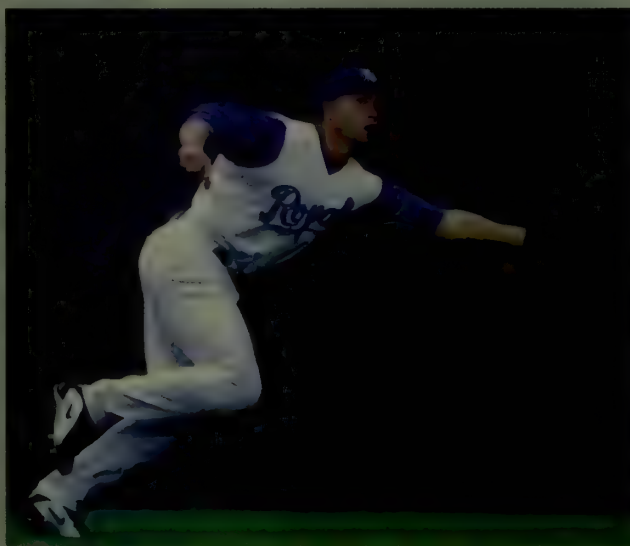
This time, Selig wasn't serving up the usual management pabulum. As Major League Baseball (MLB) enters the home stretch this month, it's in the unfamiliar spot of being awash with unpredictable finishes. On Sept. 16, 15 teams of baseball's 30 franchises were in the hunt for post-season glory. The flush Yankees and Braves seemed bound for the playoffs, as usual. But so might be tightfisted also-rans such as the Florida Marlins and Kansas City Royals.

The hot races are good news for baseball. More fans are dreaming of miracles this fall, and some of them are showing up at ballparks. Attendance is up 47% in Miami and 27% in K.C. The nomadic Montreal Expos, owned by MLB and playing 22 games in Puerto Rico, have posted a 21% gain.

"I feel very good about where we are," says Selig. But there are already signs that the good feeling may not last. Chief among the troubling signals: the still-widening gap

between what rich franchises such as the Yankees pay their players and the pittance parceled out by their poor relations. Even more worrisome: Some clubs that are receiving a windfall in revenue sharing have nevertheless slashed their payrolls.

In 2002, the payroll spread was \$91 million—from the Yankees' league-high \$125 million to the Tampa Bay Devil Rays' \$34 million. This



ROYALS:
*They're
battling on*

season, the gap between the same teams is a staggering \$133 million (table). In fact, five of the eight franchises ranked at the pay-scale bottom this year reduced their budgets.

Shrinking payrolls from struggling teams are hardly what fans expected after owners and players signed a labor deal last year—one that Selig & Co. heralded as pivotal to restoring competitive balance. Two key provisions were supposed to do the trick. The first is a luxury tax assessed only against teams that exceed a payroll threshold—this year, \$117 million. The other is the most ag-

gressive revenue-redistribution system the sport has ever had. As a result, Tampa Bay receives \$20 million this season—but still cut its payroll from \$34 million to \$20 million.

Most observers agree that the luxury tax is affecting many free-spending teams—but not the Yankees, the team that owners most hoped to rein in. The Bronx Bombers started the season as the only team over the threshold and went even higher in July, when they traded for Aaron Boone, a \$3.7 million-a-year third baseman. Meanwhile, the Los Angeles Dodgers, who arguably are one potent hitter away from a playoff spot, made only modest moves. "There has been a broad-based attempt by owners to convince fans that the \$117 million number is a hard cap, that it's not good business to go above it," says Scott Boras, agent for Texas Rangers all-star Alex Rodriguez.

Revenue sharing shifts about \$265 million from rich clubs to poorer ones this year. But so far, teams on the receiving end aren't spending their way to the top. "Those clubs are taking the proceeds and investing for the long term in player development," explains Rob Manfred, the owners' chief labor negotiator. But Tony Attanasio, the agent for Seattle Mariners star Ichiro Suzuki, doesn't buy that line. Some owners are pocketing the windfall, he suspects: "That's truly a disgrace. Those funds should be directed to putting a winning team on the field."

So if revenue sharing isn't behind this season's seesaw playoff races, what is? Chalk it up partly to clever talent evaluators in Kansas City, Miami, Montreal, and Oakland who have their plucky teams playing as

well as rivals with far gaudier payrolls. All in all, it should be a nail-biting final weekend. Just don't count on it again next year.

As the Yankees' Payroll Soars...

	2002	2003	STANDINGS
	MILLIONS		(As of Sept. 16)
NEW YORK YANKEES	\$125	\$153	Five-game lead in AL East

The Lowest-Payroll Teams Cut Back

MILWAUKEE BREWERS	\$50	\$41	17 games back in NL Central
KANSAS CITY ROYALS	47	41	3 games out in AL Central
TAMPA BAY DEVIL RAYS	34	20	33 games out in AL East



DODGERS: Only modest moves

Hyman is contributing editor for Sports Business.



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The Corporation

STRATEGIES

HERSHEY: CANDY IS DANDY, BUT...

Can the company cook up some tasty new snacks?

Richard H. Lenny's first two years running Hershey Foods Corp., based in Hershey, Pa., have been anything but a stroll through Candyland. In the spring of 2002, a year after Lenny became CEO, Hershey was hit with a nasty labor strike. Then, just weeks after settling that dispute, Lenny acknowledged that the trust that controls the company, established by founder Milton S. Hershey, wanted to sell it. "It's been a wild ride," Lenny says now.

The sale was called off a year ago, in the face of massive community and political opposition. But now Lenny has to prove that he's up to the mounting competitive challenges facing the chocolate maker. Hershey is under relentless pressure in the \$60 billion U.S. snack market from bigger and richer food giants—all with the global reach Hershey lacks—that are working to woo customers away from candy. Hershey dominates the U.S. chocolate candy business. But chocolate is less than 15% of the total snack market, which is growing at twice the clip of the candy market. Shoppers increasingly are passing up Hershey sweets in favor of chips, sports bars, or granola-coated munchies.

The first outsider to run the company in its 109-year history—Lenny made his name turning around Nabisco Biscuit Co. before it was acquired by Kraft Foods Inc. in 2000—has undeniably made some headway. Over the past two years, he has orchestrated an ambitious overhaul, slashing costs, shuttering facilities, and cutting layers of middle management. He got rid of weak product lines, such as Luden's throat drops, and dropped hundreds of slow-selling package sizes. Lenny improved distribution, boosting Hershey's presence in convenience stores, where margins are higher than in supermarkets. He also introduced much-needed new products. Now, Lenny is devising a plan to push Hershey beyond candy and grab a piece of the faster-growing snack market.

The moves so far have increased Hershey's margins, which were among the

lowest in the industry, and its stock price. Morgan Stanley analyst David Adelman now figures net income from continuing operations will be up 8.2% this year, to \$472 million, compared with the low single-digit increases of the late 1990s. But sales, he predicts, will rise scant 1.2%, to \$4.2 billion. Hershey stock price, recently \$72.57, is up about 12% since Mar. 9, 2001, the day before the announcement that Lenny would take over, vs. a 4.6% gain for the Standard & Poor's packaged-food index.

But the big problem before Lenny arrived is still there, sitting as shiny as a neatly wrapped Hershey's Kiss: How can the company grow? On Wall Street, skepticism remains that Lenny can hit his promised sales-growth goals of 3% to 4% per year. That's well above the 1.3% compound annual growth rate the company generated from 1997 to 2002, and higher than the recent 2% to 3% growth in the chocolate candy market. Many analysts think Hershey's goals are a stretch. "To do that I think they have to broad-



...beyond chocolate candy," says Prudential Securities Inc. analyst John M. McMillin.

Lenny's rejuvenation of the Hershey sales force should help. The company has beefed up the number of sales reps servicing customers. That helped it gain ground in convenience stores. Derek J. Schmitt, category manager for candy at 7-Eleven Inc., says Hershey is better now at providing displays that work with 7-Eleven's limited shelf space and at giving more advance warning of new product launches. "I know what I'm going to be doing with Hershey next June," says Schmitt. "Before, they'd usually drop [a new product] on your desk about a month before it became available."

In fact, before Lenny came, the company's new-product machine had sputtered. Instead of launching one big product every year or two, Hershey now has a steady stream of new products and line extensions, such as Reese's

Inside Out Cups—peanut butter on the outside, chocolate inside—and the upcoming Swoops, chip-shaped versions of some Hershey candy bars. Hershey has even begun making sugar-free chocolates this year, though they are a minuscule part of total sales.

Overall, Hershey has managed to gain market share in recent years in the U.S. chocolate candy segment. Its 43% dwarfs the 27% share of Mars Inc. and the 9% of Nestlé.

But dominance in chocolate will only take Hershey so far. The overall snack business, which is growing at about 5% a year, according to Prudential's McMillin, is becoming more competitive. General Mills Inc. and Kellogg Co. are nibbling away at the candy market with snacks like their Honey Nut Cheerios Milk 'n Cereal Bars and Nutri-Grain bars, respectively.

The best way into the broader snack market, say some experts, may be the path Lenny is taking, which is to build



LENNY: Trying to extend existing brands

on existing brands rather than creating new ones from scratch. "Rather than launching new brands, which are expensive and destined to fail," says Gary M. Stibel, founder of New England Consulting Group, "Lenny is focusing more time, people, and money on power brands and smartly extending them."

The company has done extensive market research and testing of possible new products under its existing brands, which include Almond Joy and York Peppermint Patties. While he won't get specific, Lenny says new snacks could include cookies, crackers, or snack bars. "We know our brands can travel," says Lenny.

Hershey's options for traveling outside the U.S. are limited, however. Tentative moves to expand in Europe in the 1990s were stymied by entrenched competition and the high cost of potential acquisitions. Lenny says Hershey will look at "creative" ways to expand in such markets as Asia and Latin America, where it already has a toehold. But even joint ventures have limited appeal, given that rivals such as Mars and Nestlé are already established globally.

Lenny is clear about one thing: Hershey won't be on the block again. The trust has said so. That provides some sense of stability for management, and for the town of Hershey, Pa. But it also means investors have to trust Lenny's overhaul to sweeten their returns.

By Amy Barrett in Hershey, Pa.

HERSHEY'S HURDLES

Now that the sale of the company is off, CEO Rick Lenny has set his sights on significant growth

1.3%

Average revenue growth in past five years.

Without new snack products, Lenny may find it hard to achieve the 3% growth he's aiming for.

\$60 BILLION

Size of U.S. snack market.

Hershey dominates chocolate candy but has few offerings in faster-growing categories such as cereal or power bars.

90%

Share of Hershey sales from North America.

Boosting offshore revenues will be tough. It will likely require experienced partners—or lots of cash.

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Founder of INVESTOR'S BUSINESS DAILY

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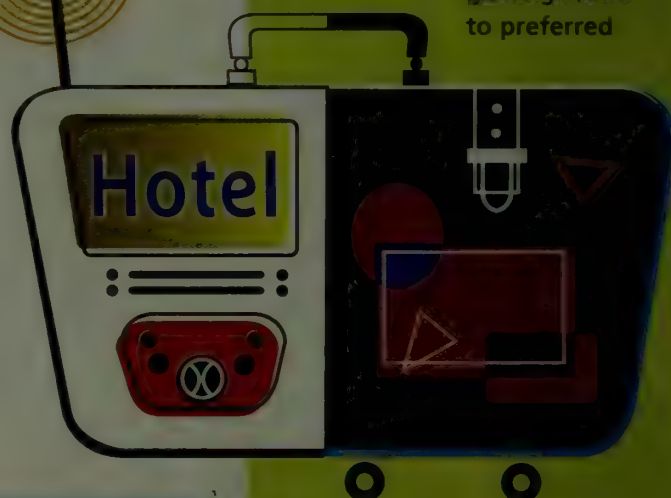
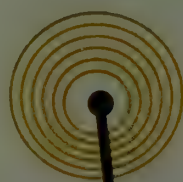


Corporate Travel:

REDUCING T&E, STAYING PRODUCTIVE



As the global economy recovers and pent-up demand for business travel leads to a burst of spending, all eyes are on corporate travel managers. Charged with the task of keeping costs down, the savviest of them have turned travel purchasing into a tightly controlled, carefully monitored business process. By setting several basic policies in place—mandating the use of a single travel agency and single corporate card, both of which capture ‘clean’ spending information, then forging preferred-supplier agreements to lock in advantageous prices, companies are leveraging their market share to save hard dollars. And by streamlining the researching/purchasing/expense accounting process, they are also saving considerably on process costs. At Xerox Corporation, for example, the company is able to save \$1.1 million a year after implementing a Web-based electronic expense management solution.



Starwood Preferred Guest® Program Teams up with Tumi®

Starwood Preferred Guest is teaming up with Tumi, purveyors of contemporary, cutting-edge luggage and accessories. Through this partnership, Starwood Preferred Guest will offer members exclusive access to Tumi private sales, special Tumi incentives for frequent stays, and the opportunity to redeem Starpoints® for merchandise at Tumi.com.

Tumi customers will benefit too, gaining access to preferred

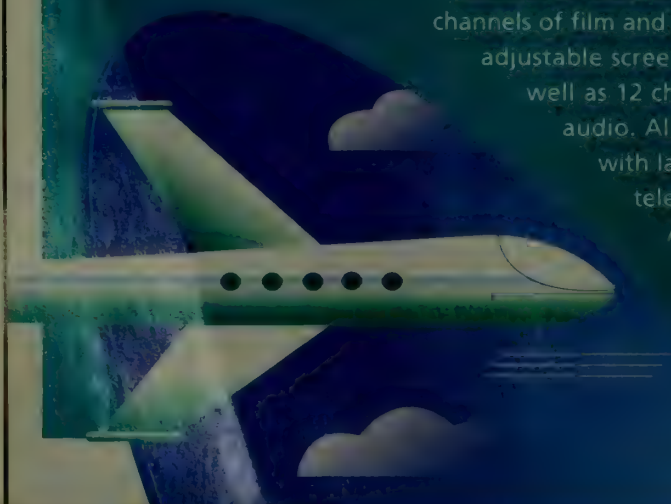
British Airways Offers First Flat Beds in Business Class

British Airways is the only international airline to offer a seat that converts to a completely flat, six-foot-long bed for business-class travelers. The seats are designed in forward and rearward facing pairs, creating a lounge-style environment. Each armchair-like seat, complete with adjustable footstool, converts to a flat bed at the touch of a button. The cabin layout is designed to maximize personal space and privacy, with each seat also featuring individual privacy screens which can be opened or closed, depending on whether customers are traveling alone. Traditional side-by-side seating is also available.

Travelers are also treated to a choice of 18 channels of film and TV with a generous, adjustable screen for easy viewing, as well as 12 channels of CD quality audio. All seats are also wired with laptop power points and telephones, and British Airways is currently testing in-flight two-way Internet service, using wireless Wi-Fi technology.

membership status in Starwood Preferred Guest and scoring high-value incentives, including free nights when they stay at any of Starwood's hotels and resorts. Since 1998, Starwood has boasted more hotels on Conde Nast Traveler's Gold List of the "best places to stay" than any other hotel company. Starwood brands include Westin, Sheraton, Four Points by Sheraton, St. Regis, The Luxury Collection and W Hotels.

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TRAVEL MANAGEMENT 101

Travel management isn't just about controlling costs; it's about the thoughtful collection and review of information. Travel managers closely monitor their agreements, to see whether negotiated discounts are actually used by travelers; whether contracts sufficiently match travel demand; whether contracted rates beat market rates; and where "rogue" spending — bookings made out of policy — takes place and how it is acted upon.

Another area where travel managers have exerted important influence is the migration toward automated travel booking systems.

Why have employees gone through the exercise to book online, when a corporate travel agency can do it for them? The answer is time and money.

When Motorola launched an online booking system, it saw average ticket prices immediately fall about 20 percent. Citibank and Lucent Technologies saw ticket prices fall as much as 25 percent. Travel professionals call this phenomenon "visual guilt;" it's proof, they point out, that when travelers are shown a wide variety of travel options, they will scout out the ones that put the smallest dent in their travel budgets.

The other advantage to self-bookings: lower agency transaction fees. Offline fees are typically \$30-\$75, depending on the complexity of the reservation. By contrast, online fees are \$15-\$22.50 per transaction. As an example, a major U.S. corporation with 23,000 travelers and \$40 million in annual air billings, that mandates the use of an online booking tool, now saves 50 percent in transaction fees. That, plus the \$2.5 million it saves when travelers make cheaper choices, has led to \$4 million total savings on travel costs.

For companies that do not have an automated booking solution in place, or have not yet organized a

managed-travel program, several commercial Web sites offer corporate-travel booking capability. Travelocity (www.travelocity.com) and Orbitz (www.orbitz.com) both have a high percentage of corporate users — sometimes more than one-third. SideStep (www.sidestep.com) searches inventory from all travel sites — computer reservations systems, private-label sites like Southwest Airlines and JetBlue, online agencies (including the two mentioned above), hotel and car rental companies, even consolidators, to find the best possible price options.

Don't want to be entirely reliant on the Web for travel bookings and assistance? Many companies are successfully using a bricks-and-clicks approach: encouraging do-it-yourself bookings whenever possible and using a travel agent when itineraries get too complex. Expedia (www.expedia.com), recently capitalized on this trend by purchasing a large, corporate travel agency to give corporate clients the online tools they need to manage employee travel and corporate travel policies, backed by a 24-hour corporate travel customer service center.

Thrifty Car Rental Gains Corporate Constituency

Once considered to be largely a leisure-travel operation, Thrifty Car Rental has recently shifted its focus toward seeking corporate accounts, then rewarding them with special perks and privileges. "We're

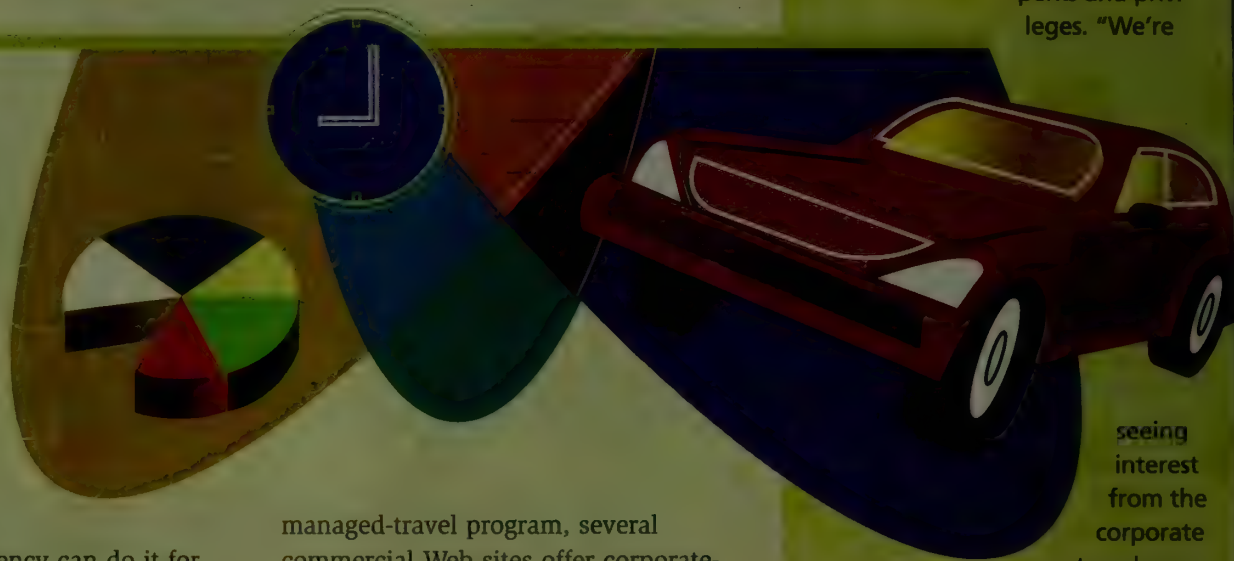
seeing interest from the corporate traveler we

haven't seen before,"

Donald Himelfarb, president of Thrifty, told *Business Travel News*, explaining that price transparency on interactive travel Web sites Expedia, Travelocity and Orbitz is making a compelling case to cost-conscious consumers — and their CFOs.

Thrifty's generous Corporate Account Program offers companies of all sizes — from conglomerates down to sole proprietorships — a series of important benefits: unlimited mileage in the 48 contiguous states, 15 percent discounts on airport parking at Thrifty's 40 Airport Parking facilities, and automatic enrollment in the Blue Chip Express Rental Program.

Thrifty has rental locations in 70+ countries, and has kiosks inside terminals in more than 120 airports in the U.S. and all major airports in Canada. Besides advantageous rates, Thrifty also offers a special bonus: the traveler's choice of miles or points (with 15 airlines plus Hilton Hotels) every time they rent from Thrifty.



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DYNAMIC TRAVEL MANAGEMENT

It's an interesting time to be in travel management. Demand has been depressed for more than two years, competition is stiff, and suppliers are now willing to deal. All in all, it's a fortuitous time to leverage your company's spending power.

"It's very much a buyer's market. And recognizing this, suppliers have become more innovative," says Matthew Davis, global director of consulting services for American Express.

The unusual cooperation between travel supplier (airline, hotel company, travel management firm, car rental) is all part of a move away from traditional approaches to travel purchasing, which involve contracts and discounts with volume guarantees, to a more flexible



one that allows for 'spot buying'—locating bargains, then making short-term agreements. Companies are also switching from a dollar guarantee to a market share agreement. That way, no matter how much is spent quarter over quarter, there may be a benefit in moving all of your market share to a particular airline or hotel chain. Some companies are aggregating their business through a mega-travel agency that has sufficient traffic to make so-called 'cluster deals.' Others are using airlines' tiered pricing programs. American Airlines, Delta and US Airways offer point-of-sale discounts in exchange for a certain volume or market share. The discount level varies by quarter, depending on how well the company performs against the agreed-upon goal.

Other ways to apply dynamic pricing principles is to consider the total cost of a trip. It's not just a matter of booking a low-cost carrier, Matthew Davis pointed out, but whether that route makes sense as an option. "Beware of false economies," he warns. "The fares may look tempting, but these low-cost carriers may not fly from primary airports into primary airports." Flying from London into Lubeck airport, which is 60 km from Hamburg, or to Hahn, which is 100 km from Frankfurt, for example, means that taxi transfers actually may cost more than the airfare. "Time is money," says Davis, "and having to leave a meeting two hours early to catch the last flight of the day may not make the most business sense."

False economies also lurk in unlikely places. In Europe, where low-cost airlines have become hugely popular, major carriers are stepping up competition on certain city-pairs, offering the network airline services (frequency, frequent-flyer points, use of major airports, comfortable airport lounges, meals on flights) at prices

nearly comparable to—sometimes less than—their no-frills competitors. British Airways has been so successful at competing with the low-cost upstarts in Western Europe that it was recently named as the "best low cost airline" in an annual poll organized by The Guardian newspaper in the UK. British Airways, which restructured its European and domestic fare structure in summer 2002, now offers new reduced fares on more than 170 routes across the continent.

In the hotel sector, some companies are trying reverse auctions, inviting hotel companies to bid prices down for the chance to become a preferred supplier in a company's travel program. According to *Business Travel News*, Hewlett-Packard has held 34 reverse auctions this year, largely in markets where hotel competition is intense, and hoteliers are willing to live with paper-thin margins.

Still, with travel rebounding, there soon may be less maneuverability in price. In many markets, prices already are so depressed there's no more room to move down, so instead, companies are focusing on adding value through amenities rather than squeezing out any further discounts. Anything that can be built into a rate that could save the company money—free breakfast, free parking, and discounted or free telephone calls, for example—are routinely part of negotiations.

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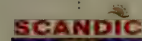
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PORTAL POWER

Since it's now well established that the more companies encourage travelers to book their arrangements themselves, the more money they can save, methodology that makes self-booking fast and uncomplicated is high up on the corporate priority list. To that end, a number of so-called travel portals are being marketed to facilitate the research and booking process of travelers and travel arrangers, who otherwise would engage the services of a travel agent.

Each of these portals is customized for each corporate client, showing only those travel options that fall within a particular company's travel policy, and directing travelers to preferred suppliers only. Some are accessed only via a corporate Intranet; others from an Intranet or the Internet. Many portals are now configured to display Web fares, so travelers have access to airline inventory they otherwise would have to access outside the corporate booking system. (Up until recently, for example, it was only possible to book a JetBlue Web fare by doing so directly from the JetBlue Web site, *not* via a portal.) Leading portals include the following:

GetThere, a Sabre Holdings company, is a leading provider of Web-based travel reservation systems for both corporations and major airlines. GetThere's systems are used to provide Web-based travel procurement, including air, hotels, car rentals, trains and meeting planning to employees at such leading companies as Boeing, ChevronTexaco, Cisco, Credit Suisse First Boston, Honeywell, PricewaterhouseCoopers and SBC Communications. (70 percent of the largest corporate travel spenders

and availability, compare routes, and make changes to itineraries on the site as well.

In August 2003, Cendant Corporation launched **Travelport Corporate Solutions, Inc.**, offering corporations a customizable business travel portal that Cendant claims helps reduce overall travel management costs up to 40 percent. More than 275 companies, including Microsoft, Nike Inc., and Siebel Systems, are already taking advantage of what Travelport has to offer.

The new company leverages brands within Cendant's Travel Distribution Services Division, by integrating Highwire, the online corporate booking tool; Galileo International, a leading global travel distribution services (GDS) company; and Cendant's travel agency, which provides global fulfillment and 24/7 customer service for Travelport users. The booking engine includes user-friendly features: complete online processing for airline ticket changes, e-notification of hotel confirmations, changes and cancellations, and access to premium economy fares on international flights.

that have selected a portal system use GetThere.) GetThere has earned high marks for ease to use: employees log onto their corporate Intranet site, and click on the travel icon. From there, reservations are only a few more clicks away. Travelers can also check prices

Avis Rolls Out Motorola Navigation System Nationwide

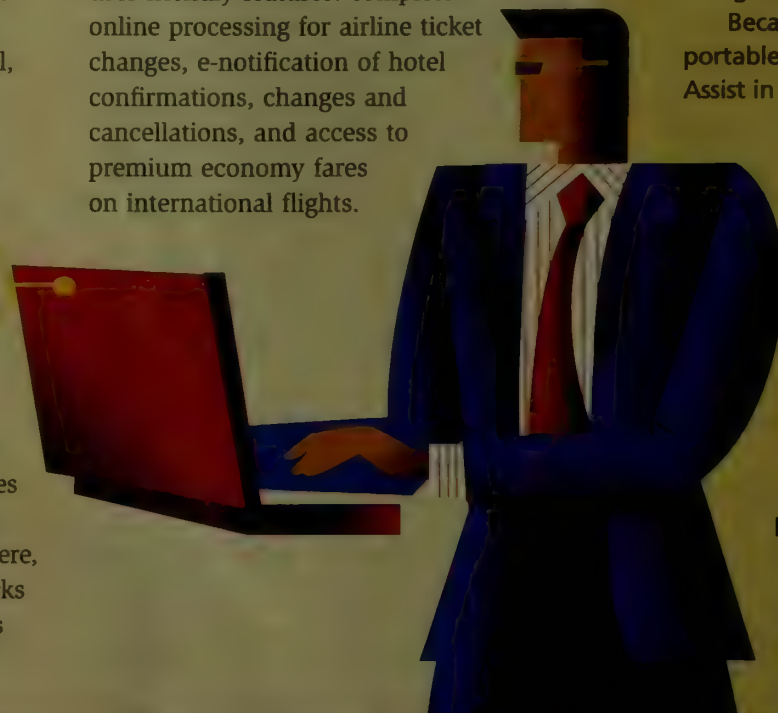
Avis Rent A Car System, Inc. has an interesting new way to help travelers drive safely and efficiently in unfamiliar destinations. A new partnership with Motorola makes the "Avis Assist" phone-based navigation system available in up to 50 cities



across the United States and Canada. Customers simply rent a Motorola phone with GPS (global positioning system) capabilities through Avis; speed-dial the call center and tell the representative (via speakerphone) an address. They're then connected to a location-based navigation service that literally talks them through directions, broadcasting street names and driving maneuvers along the route.

Because the phone is portable, renters can use Avis Assist in or out of the vehicle, and Avis can provide a navigation system in any car type that it rents.

Avis and its subsidiaries operate in more than 1,700 locations worldwide. Avis is one of the world's top brands for customer loyalty, tying for number one in the 2003 J.D. Power & Associates rental car customer satisfaction study.



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Avis features GM vehicles like Pontiac Grand Prix

Marriott Rewards Grow More Rewarding

With more than 18 million members and 2,300 participating hotels in 65 countries, Marriott Rewards is the largest and most popular frequent guest program in the world. In addition to free hotel stays, members may redeem

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Internet or a corporate Intranet. An online management tool allows travel managers to update travel policy in real time and push changes directly to American Express travel counselors' point-of-service tools and

the corporate online booking tool. In addition, the portal can be customized with messages, warnings, policy changes, and other important information, as well as links to maps, driving directions, and currency conversion tools.

Another special feature: Ticket TRAX NR, which helps managers keep track of unused nonrefundable (but still usable) tickets.

e-Travel, the e-commerce business unit of **Amadeus Global Travel Distribution**, has a portal of its own: Aergo, which is designed as a module for Oracle's ERP system. The recent integration of Aergo with Oracle's Internet Expenses module lets employees quickly plan and book

their own travel itineraries, and fill out their own expense reports, 24 hours a day. Oracle said it would be working toward further integration of Aergo with iProcurement, Oracle's Internet-based solution for streamlining the procure-to-pay business process.

Aergo is one of the world's most widely deployed online solutions for global managed travel. It is currently used in more than 20 countries, enabling employees in some 250 corporations to plan and book complete travel itineraries in compliance with corporate guidelines and within a secure online environment.

e-Travel managing director Ian Wheeler noted that corporations using Aergo can save up to 30 percent on their annual travel expenditure and typically see a full return on their investment in the initial year of implementation. "Customers are demanding more and more integration into their existing Enterprise Resource Planning systems, expense programs, workflows, and business intelligence," he said. "By adopting our integrated Travel Management Solution, customers will be able to reap cost efficiencies, process improvements, time savings, and enhanced productivity."

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Writer: Jill Molyneaux is a business travel specialist and former editor-in-chief of *Corporate Travel* magazine.

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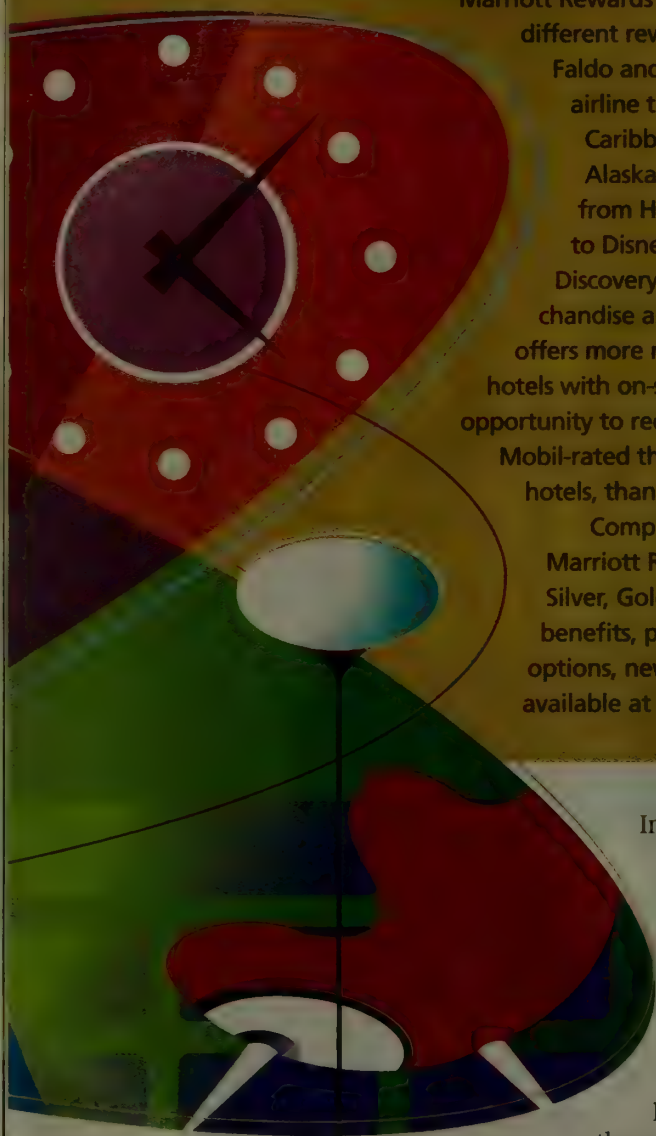
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Travelport's so-called 30-30-30 allows most corporations to implement the tool in 30 days and achieve 30 percent adoption within the first month, leading to an average 30 percent cost savings, says a company spokesperson.

American Express's TravelBahn™ portal gives travelers and travel managers centralized access to a host of travel service tools and travel-related links. Through TravelBahn, travelers can update their personal profile in real-time, view travel itineraries and invoices, manage their expenses, and access their online booking engine — anytime, anywhere. Access is via the



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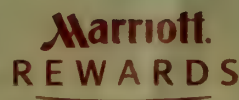
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Creative Clot-Busting

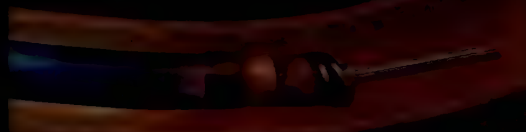
Concentric's novel device widens the window in which patients can be treated after a stroke. Here's how it works.



A **CATHETER** is snaked through the groin and into the blocked artery in the brain.



A **TINY FLEXIBLE WIRE** with coils on the tip is pushed through the catheter into the clot. The coils grab the clot.



THE CLOT IS PULLED into a larger catheter and sucked out of the body.

HEALTH CARE

SNAKING OUT STROKES

Concentric is testing a corkscrew for clogged arteries

When Bill Schlosberg came down with a crushing headache on Feb. 23, he didn't know he was having a stroke. He made it from his home in Overland Park, Kan., to the emergency room, where doctors eventually pinned down the cause of his pain. Unfortunately, he wasn't eligible for conventional drug treatment to break up the clot blocking an artery in his brain. So they transferred him to a stroke specialty center, where doctors

threaded a catheter into the artery and delicately dislodged the clot. Schlosberg, a 56-year-old engineer who was initially paralyzed by the stroke, regained most of his lost motor function a few days later. "Without this treatment, I don't think I'd be here now," he says.

The tool that saved Schlosberg's life is still being tested, but stroke specialists are already buzzing about it. The device, called the MERCI Retriever, is literally a corkscrew for brain clots. In-

vented at the University of California at Los Angeles and developed by Concentric Medical Inc. in Mountain View, Calif., it is expected to be submitted for Food & Drug Administration approval by the end of October.

If Concentric's device gets the green light, it could be a godsend for a huge and seriously underserved group of patients. "Ischemic" strokes—those caused by blood clots—account for 85% of the 700,000 strokes diagnosed in the U.S. each year, according to the American Heart Assn. Stroke is the third-leading cause of death. And the paralysis and loss of brain function that often result make it the No. 1 trigger of long-term disability. What's especially disheartening is that there's only one drug approved for treating strokes. And only 2% of patients can get it—largely because it must be given within three hours of onset of stroke, which is notoriously tough to diagnose.

The Concentric device may be usable six or even eight hours into the stroke. "Expanding that time window would be

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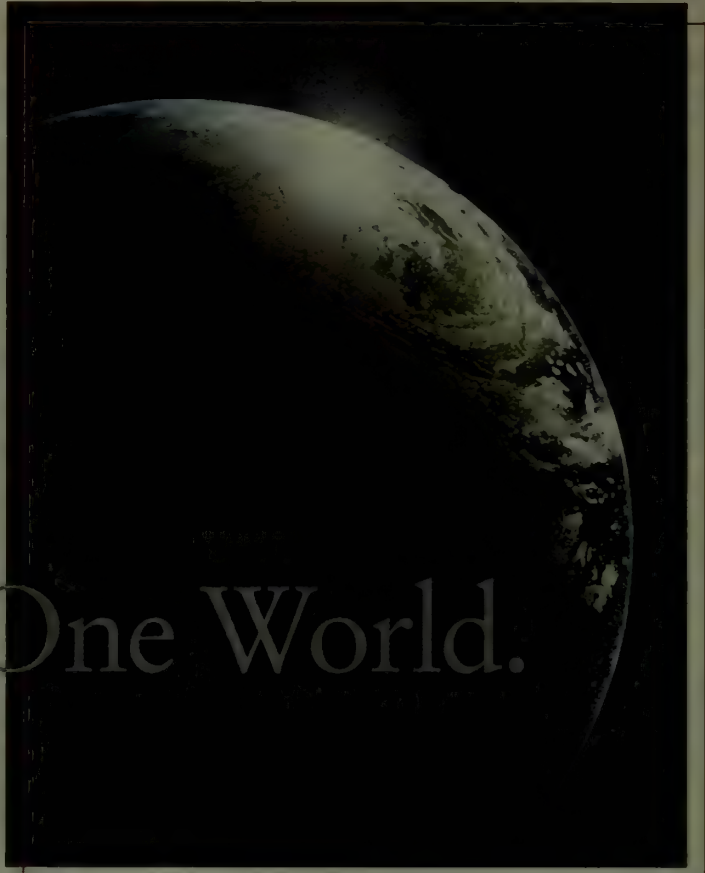
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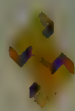
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In 2000, The United Nations identified and charged its members with solving the eight most urgent global challenges facing humanity by 2015. Each year, The Tech Museum Awards honor those who are using technology to address these challenges. This year, more than 500 nominations were submitted from 70 countries. 25 Laureates were selected. On October 15, five recipients will be awarded a total of \$250,000.



TheTech

For more information on The Tech Museum Awards or to
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breakthrough," says Dr. Marilyn Ymer, medical director of the stroke center at Mid America Brain & Stroke Institute at Saint Luke's Health System in Kansas City, Mo., which treated Chlosberg as part of a clinical trial. And it could be a windfall for Concentric: CEO Gary Curtis estimates if he reaches just 20% of stroke patients each year, the company could pull in \$850 million in annual sales.

Success is far from certain, however. The stroke field is littered with experimental devices that sounded great but ultimately failed. The problem is, the walls of the blood vessels that feed the brain are tissue-thin and extraordinarily fragile. The slightest tug can cause debilitation—sometimes even fatal—bleeding in the brain. No one has been able to fashion a device strong enough to remove clots yet soft enough to leave arteries unscathed. "It has been a design challenge for years," Curtis says.

The company could face a nervous FDA. The medical-device industry has suffered a series of setbacks this year, including the revelation that Indianapolis-based Guidant Corp. failed to report malfunctions—some leading to deaths—of a device sold for treating abdominal aortic aneurysms. Guidant paid \$92.4 million in fines to settle federal felony charges in June. Given such disappointments, the FDA is bound to scrutinize Concentric's safety record before letting hospitals stock up.

So far, Concentric seems to be on the right path. The Retriever has worked in about 50% of the patients tested. In contrast, the only clot-busting drug approved to treat strokes, Genentech Inc.'s Activase has a 33% success rate. Curtis says less than 5% of patients treated with the device suffered bleeding or other debilitating side effects. Activase has a 6% complication rate. Better yet, there is evidence the two treatments may be complementary: Some of the patients in the Concentric trials were given injections of Activase directly into their brains to dissolve remnants of clots the Retriever couldn't reach.

The secret to the Retriever's clot-busting talent is in its design. It is made of a "shape memory" alloy—the same

kind that's used in flexible eyeglass frames. That means it can be molded so it's perfectly straight when it is threaded through a catheter that is inserted into an artery in the brain, but when the wire protrudes from the end of the catheter, it automatically reshapes itself into tiny coils that latch on to the clot (diagram). A balloon at the end of the catheter inflates to stop blood flow temporarily through the artery so the clot can't break free and travel away. The clot is then pulled into a second, larger catheter and sucked out of the body with a syringe. In some cases, the procedure can be done in as little as 20 minutes, whereas Activase, given intra-

venously, can take an hour or more to dissolve a clot, says Dr. Sidney Starkman, clinical professor of emergency medicine and neurology at UCLA.

The Concentric tool offers more than a time advantage. It may be a lifesaver for patients who can't be given clot-busting drugs because the risk of catastrophic bleeding is too high. People who have recently undergone surgery, for example, can't be treated with Activase. In a trial at UCLA Medical Center, doctors were able to use the Concentric tool on a woman in her 30s who

had suffered a stroke two weeks after giving birth by cesarean section. She arrived at the hospital unable to speak or move on her right side. With one tug of the Retriever, "she was made normal immediately," Starkman says.

If Concentric wins the FDA's consent, the company will face a whole new set of hurdles. It will have to train stroke specialists, most of whom have never used medical devices for this purpose before. And at first, the device may be available only in a handful of specialty neurology centers. Concentric has pulled in \$25 million in venture capital so far, but execs say they will need to raise another round to properly launch the product. Despite the challenges, Curtis says, "we're excited. There is no choice for some of these patients. To provide that for them would be the greatest high there is." Certainly medicine could use another powerful weapon against one of its most sinister foes.

By Arlene Weintraub in Los Angeles



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Developments to Watch

BY OTIS PORT

SEEING-EYE CD PLAYERS FOR THE BLIND

THOSE TEENSY SILICON CHIPS that help keep track of products in warehouses may one day open up new vistas for the blind. University of Rochester students under Jack G. Mottley, an associate professor of electrical engineering, have built a system that uses radio-frequency ID (RFID) tags and a portable CD player to deliver spoken navigation guides to designated places. For example, a CD guide to a college campus could respond to RFID tags mounted on doors and buildings by announcing "Professor Mottley's office" or "entrance to the physics building is five steps up."

The system, Navigational Assistance for the Visually Impaired (NAVI), uses tags as small as rice grains, that cost about 25¢. Each emits a distinctive code when triggered by a radio signal from NAVI's antenna, which resembles a handheld microphone. The code tells the CD machine what segment to play. A polished version of the toaster-size prototype, predicts Mottley, could pack everything inside a portable CD player.

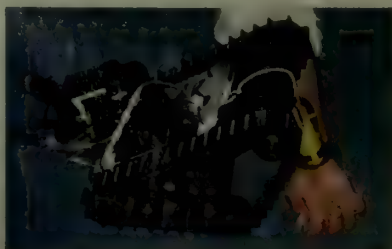
ROBOTS AMONG THE RUINS

LAST MONTH, AFTER A MOCK earthquake partly demolished the old town library in Lebanon, Ind., small robots crawled into the rubble, searching for the half-dozen mannequins that had been planted in the building before it collapsed.

It was just a practice session for a team from the University of South Florida's Center for Robot-Assisted Search & Rescue (CRASAR), but devices like these are already

functional: After the September 11 terrorist attacks two years ago, CRASAR helped probe the rubble in New York with remote-control robots—and found body parts.

Since then, CRASAR director Robin R. Murphy has been busy developing new sensors so bots can tell if a victim is still alive. That way,



GO GET 'EM: Rescue by robot

she explains, rescue workers won't waste precious hours digging out dead bodies while there's still hope of finding survivors. One sensor detects blood flowing in a victim's veins by touching exposed skin. If the robot can't get that close, another sensor can pick up exhaled carbon dioxide from a few feet away.

Next up, says Murphy, could be remote-controlled robots that can deploy and inflate air bags to prop up the rubble around a survivor. That tops the to-do list for the new industry-university center CRASAR is now setting up, aided by the National Science Foundation.



USING GERMS TO LIBERATE NATURAL GAS

WITH ELECTRIC UTILITIES CONSUMING NATURAL GAS IN record volumes, the price of this clean-burning fuel has soared. Environmentalists would like to boost supplies, which also would please homeowners stuck with rising heating bills. At Brookhaven National Laboratory, researchers led by chemist Mow Lin are working on one solution: "mining" methane from coal with bacteria. The main component of natural gas, methane, is also trapped inside coal, the world's most abundant fuel. But current methods of liberating it produce lots of polluted water.

To address that, Lin's crew is evolving new strains of bacteria that not only help catalyze the release of the methane but also transform the contamination into benign compounds. Lin collected the ancestors of his bugs from such places as hydrothermal vents on the ocean bed. There, they thrive in a toxic stew hotter than boiling water, so they have a natural aptitude for the job Lin hopes to give them.

INNOVATIONS

■ For centuries, scholars have praised sage for more than just its pretty lavender-colored blossoms. "It also heals the memory," according to a 1652 textbook. And so may—for at least a couple of hours. Researchers at Britain's Medicinal Plant Research Center gave 44 volunteers either sage oil or placebo capsules and tested their ability to recall a list of words up to six hours later. Over the next three hours, those who got sage oil scored much higher. More trials are under way to see if sage oil also can mitigate the effects of Alzheimer's disease.

■ Heat from nuclear waste could be used to seal it safely away, deep within the earth's crust, according to a report in the August issue of *Geology*. British engineer Fergus G.F. Gibb proposes dumping radioactive waste into holes three miles deep. The "hot" waste would melt the solid granite rock, which would soon resolidify, forming a protective tomb that should last nearly 1 billion years—far longer than the estimated 10,000-year life span of containers at the Yucca Mountain repository in Nevada.

■ Foodmakers may soon be able to cut salt and sugar in their snacks without sacrificing flavor. Researchers from Germany's University of Münster, working with Nestlé scientists in Vevey, Switzerland, have identified a new flavor enhancer called alapyridaine that increases both saltiness and sweetness. The compound was discovered in beef stock and is itself tasteless. So far alapyridaine shows no signs of triggering the headaches and other irritating side effects caused by MSG, the standard flavor enhancer.



Information is the best medicine.

Having better information can help you make more intelligent health care decisions. So we provide a host of helpful information resources, like our Aetna IntelliHealthSM online health information site, offered in association with Harvard Medical School. Here you'll find a wealth of knowledge about diseases, conditions, treatments, preventative measures, and much more. At our Aetna NavigatorTM Web site, members can receive their benefit statements and review claim status electronically. And soon, we'll provide you with survey data to help you assess the quality of doctors and hospitals in our networks. The information to make intelligent choices—that's a prescription for quality health care coverage, from Aetna.



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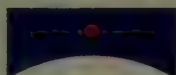
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BUSINESS OBJECTS®

COMMENTARY

By Lorraine Woellert

THE DO-NOT-CALL LAW WON'T STOP THE CALLS

When President Bush launched the Do-Not-Call registry in June, he said it would "help Americans protect their private time or family time." Added the Prez: "Unwanted telemarketing calls are intrusive, they are annoying, and they're all too common." Consumers overwhelmingly agreed: More than 50 million Americans signed up for dinnertime peace.

But that ringing you'll hear when the law takes effect on Oct. 1 won't be in your head—it'll be your phone. The Administration's simplistic message, accentuated by media hype, has oversold the public on what the registry will deliver. The Do-Not-Call Implementation Act is riddled with loopholes, allowing everyone from your bank to resort promoters to keep on dialing. When consumers wake up to the flaws, expect messy lawsuits, political finger-pointing, public outrage, and another black eye for legitimate marketers—even those that are trying to comply.

The problem with Do-Not-Call is that its authors—the Federal Trade Commission and the Federal Communications Commission—had many people to please. Congress carved out loopholes for charities, politicians, and their paid fund-raisers. And the Administration, eager for a populist pitch to consumers without being seen as heavy-handed regulators, wanted broad business exemptions.

How broad? Every time you pay a bill, buy something, or have merchandise de-

livered, you give that company an opening to solicit you by phone for the next 18 months. Depending on how businesses interpret the law, even calling an 800 number to ask a question could be enough to trigger sales pitches for three months. And

primrose path," says Louis Mastria, director of public affairs at the Direct Marketing Assn. (DMA). "The FTC is creating the perception that you will never get a call again."

To deflect public ire, the DMA is ramping up an education campaign.

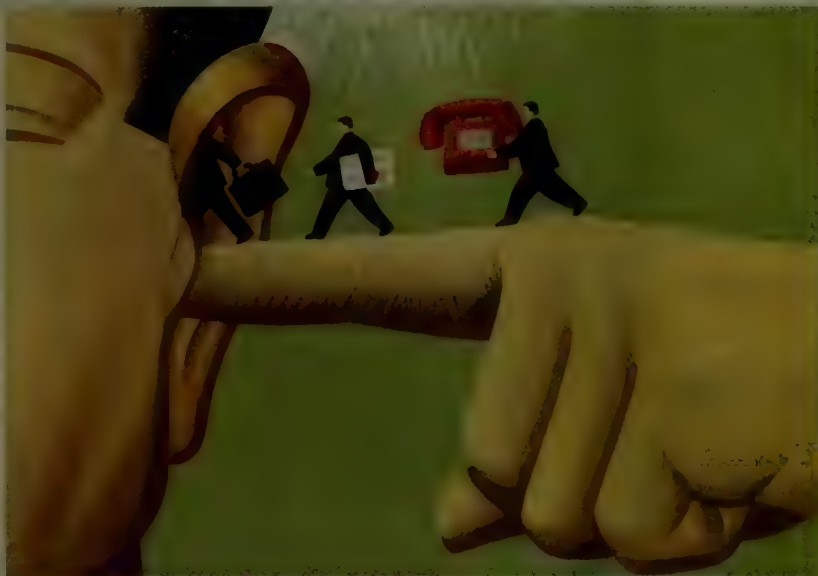
The message: In most cases, companies that call won't be breaking the law. Nonetheless, "the FTC and FCC can expect a spate of erroneous complaints," says Tim Searcy, president of the American Tele-services Assn.

Complaints, whether spurious or legitimate, might fall between the cracks, however. The FTC and FCC remain at odds on key provisions of the law, how it will be enforced, and who'll pay for enforcement. Businesses covered by

the FCC rules—including such notorious callers as phone companies and financial institutions—enjoy looser definitions for existing business relationships. The FTC conceded, in a Sept. 9 report to Congress, that businesses could exploit those discrepancies to boost calling. "This could annoy consumers," the FTC warned. Meanwhile, at least 12 states have refused to roll their own do-not-call lists into the federal list, creating yet another level of regulation.

A lawsuit challenging the constitutionality of Do-Not-Call in federal district court in Denver could put on the brakes. Telemarketers, led by Mainstream Marketing Services Inc., say Do-Not-Call restricts speech and violates the equal protection clause by establishing categories of calls to be blocked. If the judge halts enforcement, Washington should take the time to do the job right and create a bare-bones registry with no exemptions. Consumers seeking relief from phone hucksters shouldn't be sold a bill of goods by their government.

Woellert covers consumer and legal affairs in Washington.



beware signing up for in-store raffles or clicking "I Agree" buttons when buying online: You could be giving companies permission to call you.

As their pool of phone numbers shrinks, businesses will intensify their sales pitches to existing customers. Expect calls from your bank

offering to upgrade its services, for example. Callers who don't make explicit sales pitches are home free. Come-ons that announce you've won a hotel stay—if you'll only sit through an on-site sales pitch—are allowed, too.

Do consumers know about these loopholes? No. A Sept. 10 Harris Poll found that just 9% of adults are aware that the new rules apply only to for-profit telemarketers. No wonder the already bruised telemarketing industry is bracing for a backlash. "Consumers are being led down this

WHO WILL STILL BE ON THE LINE?

- Charities, politicians, pollsters, and market researchers
- Companies you do business with
- Companies that have sold you something, billed you, or made a delivery to you in the past 18 months
- Businesses you've contacted in the past three months
- Companies that obtain your permission

RETAILING

NO LONGER BIG BRAND ON CAMPUS

Are Abercrombie & Fitch's prices too rich for kids' blood?

The West Towne Mall in Madison, Wis., is bustling with young shoppers on Saturday afternoon, but at one retailer there's plenty of elbow room: Abercrombie & Fitch Co. As 1 p.m. approaches, only four customers are in the store, and two of them are heading out the door empty-handed. "You can buy two pair of jeans elsewhere for the \$60 you pay here for one," gripes Chris Budzin, 20, as he makes his exit with girlfriend Jayne Vosen, 18.

A few years ago, Abercrombie's high prices were as much a part of its cachet among free-spending teens as its preppy styles and racy marketing. Then the economy soured, and high prices became a turnoff to cost-conscious kids. To keep the registers ringing, such rivals as American Eagle Outfitters Inc. and department stores have discounted aggressively. Abercrombie chose to take the high road, eschewing promotions to preserve the brand's exclusivity and lofty margins—the highest of any teen retailer.

That reflects a discipline that lots of other marketers—are any Detroit car-makers listening?—seem to have forgotten. But critics say Abercrombie Chief Executive Officer Michael Jeffries hasn't given kids a good enough reason to pay top dollar. As Abercrombie enters its fourth year of mostly declining sales, it may be time to question whether Jeffries' noble experiment is panning out. Even as most retailers benefited from a surprisingly strong back-to-school season, Abercrombie reported on Sept. 4 that sales at stores open at least a year plummeted 11% in August.

Although Jeffries declined to be interviewed by *BusinessWeek*, he has assured analysts that sales will rebound when the economy does, and that keeping the Abercrombie brand "aspira-



tional" is the best way to maintain profits. Otherwise, he reasons, you train your consumers to expect discounts. Jeffries says he has updated Abercrombie's preppy fashion look with low-rise jeans and sexy knit tops. And he says that Hollister Co., the 3-year-old surf-inspired division that now accounts for 113 of Abercrombie's 625 stores, is off to a fast start, though the jury is out on how much it will cannibalize sales.

Abercrombie's rich profit margins kept skeptics at bay until recently. Under Jeffries, who arrived in 1992 after spending much of his career at Federated Department Stores Inc., Abercrombie ex-

ercised tight cost and inventory control. And, of course, Abercrombie has long commanded big markups—a hooded sweatshirt sets a shopper back \$69.50 vs. \$39.50 for a similar item at American Eagle. The result: Abercrombie's \$3 million in operating profits came to a hefty 20% of its \$1.6 billion sales in the fiscal year ended January 2003.

At some point, though, those margins will shrink if sales keep sliding. Abercrombie still is identified with a

JUST LOOKING

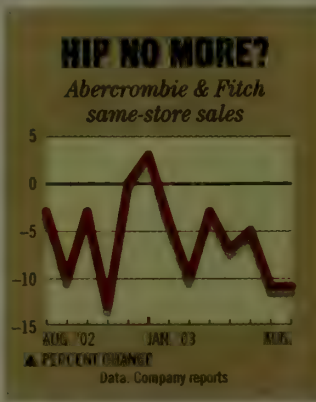
August sales fell 11% even as most retailers reported a strong back-to-school season

edgy collegiate look and logo shirts that took the teen market by storm in the second half of the 1990s. But teenage girls want more extreme styles like punk, says Irma Zandl, president of Zandl Group, New York teen market research firm. That's how rivals Pacific Sunwear, Urban Outfitters, and Aeropostale have kept growing even while holding the line on discounting. "He [Jeffries] happens to be off trend," Zandl says.

Clearly the market has shifted on Abercrombie. The question is, can Jeffries respond? Some analysts fear that customers fleeing Abercrombie for low-priced rivals won't be back. Says Marshall Cohen, chief analyst at market research firm NPD Group Inc.: "This is the first generation of teens [in years]

that has been trained to purchase on a budget." When even kids have learned how to pinch a penny, the time may have arrived for Jeffries to change course. His profits are impressive, but they won't hold up forever if customers keep voting with their feet.

By Robert Berner in Madison, Wis.



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COMMENTARY

By Louis Lavelle

AFTER THE JOBLESS RECOVERY, A WAR FOR TALENT

For two years, economists have looked at new unemployment applications with increasing alarm. But for managers on the corporate front lines, the real cause for concern in coming months could be a different population of job-seekers: the gainfully employed. With unemployment at its highest point in nearly a decade, workers lucky enough to avoid layoffs have had little opportunity to jump ship. That will change as the economy picks up. Companies will have to begin hiring if growing demand overwhelms the productivity gains that have allowed them to churn out more goods with fewer workers.

Experts predict that annual voluntary turnover could rise to 20% or more for white-collar workers, as companies bid for top talent and star employees start heading for the exits. For employers, "it's going to be quite traumatic," says Ed Jensen, a partner in the human performance practice at Accenture Ltd.

It has been three long years of doubled-up workloads, minuscule raises, and ungrateful bosses—and American workers are fed up. In the late 1990s, when even modest performers could drum up multiple job offers, such treatment would have led to a mass exodus. Today, it has many workers quietly updating their résumés and biding their time. After three rounds of layoffs in three years at her magazine, one New York editor says she's now pulling all-nighters every other week. With an out-of-work husband, she can't afford to quit, but she'll depart as soon as hiring picks up. "You feel grateful for having a job, but because of downsizing I'm doing two other people's jobs," she says. "It has just been hugely stressful."

How many people are in the same boat? Sibson Consulting says one out of six is ready to bolt. Walker Information says its survey of 2,400 employees found that 34% were at high risk for departure. And Accenture says half of all U.S. middle managers are actively looking for new jobs or will be soon. The bottom line: After

years of cracking the whip, employers who want to win the coming war for talent need to start giving their troops a compelling reason to stay.

None of this should come as a surprise. As a yearlong jobless recovery that followed the 1990-91 recession gave way to vigorous job growth in 1992, voluntary departures surged. This time around, the battle for talent could be fiercer. The current recovery's jobless stage is both more severe and nearly twice as long as in

the early '90s—and it's not over yet. The result: large numbers of employees who feel trapped in their jobs and who have no qualms about leaving. Says Frederick F. Reichheld, a Bain & Co. loyalty expert: "They're very susceptible to an offer they can't refuse."

Most susceptible of all are the people companies can least afford to lose. With budgets stretched to the limit, there are fewer rewards to go around. In 2003, pay raises for salaried employees have averaged 3.4%, down from 3.6% in 2002 and 4.3% in 2000 and 2001, says Hewitt Associates LLC. Compounding the problem, many outfits are offering the same raises to stars and laggards alike, and top performers feel underappreciated. In a recent survey of 1,100 employees, Sibson found the

best workers had the worst attitudes and were more likely to be planning a job search.

For companies left in the lurch by mass defections, it's not just a question of temporary inconvenience. Replacement costs for professional employees can be staggering—18 months pay, according to Hay Group, not including lost sales and productivity.

To avoid that fate, businesses need to get moving—now. Managers need to do a better job of differentiating stars from underachievers. Well-structured incentive pay, such as stock or options tied to specific performance goals, can help. But even that will do little to motivate employees if the job feels like a dead end. Managers should be looking for ways to give star players more responsibility, greater autonomy, and a clear shot at advancement. After all, the best time to talk your most valuable players into sticking with the team is before they've begun scouting opportunities with competitors.

Lavelle covers management from New York.



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STRIKING BACK

How the music industry charted its crusade against Web pirates

Cary Sherman's spacious office, at the far end of a long hall decorated with gold and platinum records, might as well be Hollywood's embassy in Washington. Sunlight streams through big windows across a mod suite of low-slung couches and coffee tables. For a man now vilified worldwide for suing Internet music downloaders, the president of the Recording Industry Association of America (RIAA) looks remarkably relaxed. But there's good reason for his aplomb. "Nothing about this campaign was improvised," Sherman says. "We had thought through the details long before the first lawsuit was filed."

That required monumental advance planning. From a purely logistical standpoint, the music industry's antipiracy campaign is the most complex and controversial one in history. Microsoft Corp. raids factories manufacturing illicit copies of Windows. DirectTV sues people who own unauthorized signal-decoding devices. But these efforts have focused almost exclusively solid, three-dimensional ob-

jects. Music companies are the first to wage a wide-scale attack against people who steal digital property over the Net.

As a result, the RIAA's legal war is being closely scrutinized by everyone from artists to civil libertarians—not to mention managers in industries facing similar threats. That includes movie studios, book publishers, computer-game manufacturers, software makers, and database sellers such as Reed Elsevier and The McGraw-Hill Companies (publisher of *BusinessWeek*). Music's strategy—if it works—could serve as a model for other companies. "We've got a big problem with file-sharing, too," says Bob Kruger, vice-president for enforcement at Business Software Alliance. "There are tens of thousands of places you can get software for free."

The RIAA crusade is something of a triumph for Sherman. First his team had to sort through an array of uncharted legal, technological, and public-relations problems. Then he sold a comprehensive, step-by-step solution to a contentious group of music executives. But Sherman is reluctant to discuss details of the campaign; he doesn't want to give opponents an edge, he says. The former intellectual-property attorney also declines to reveal the names of the law firms, PR whizzes, and tech advisers the RIAA has hired. "Anybody who helps us is going to be targeted by hackers," he says.

Despite the official silence, sources inside and outside of the industry have



THE GENERAL:
Cary Sherman,
president of RIAA

shed some light on the mobilization. It began to hatch in early summer, 2002, when the RIAA's staff quietly started studying the feasibility of suing individual consumers. Attorneys at Mitchell Silberberg & Knupp, Los Angeles entertainment law powerhouse, were enlisted to help under the leadership of partner Russell J. Frackman.

At the time, most music executives were still opposed to pulling the trigger on their customers. Although freaked out by sin-

THE BUILDUP TO THE ATTACK

The industry's war against individual downloaders came after attempts to shutter file-trading Web sites failed

JANUARY, 1999

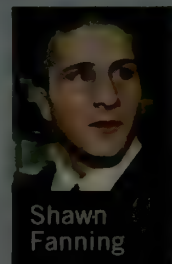
Shawn Fanning drops out of Northeastern University to work full time on Napster—the revolutionary online music service that attracts millions.



napster

DECEMBER, 1999

The RIAA strikes, suing Napster for contributory copyright infringement.



Shawn Fanning

JULY, 2000

A federal judge grants San Francisco an injunction closing Napster, but a higher court grants an emergency stay pending an appeal.

1999

2000



stance, one tricky problem was figuring out a fair way to assess royalties for monthly subscription services offering an unlimited number of songs.

Before taking teenagers to court, the RIAA also wanted to see if it could stop the problem by shutting down Web sites that facilitated piracy. Though lawyers shut down Napster in July, 2001, other peer-to-peer networks carefully designed to skirt the law, such as Morpheus and Grokster, quickly rose up in its wake. The industry sued the second-generation pirate sites in October, 2001, and was expecting a similar result in court. But on Apr. 25, 2003, a federal judge in Los Angeles ruled that Morpheus and Grokster could remain open. The devastating ruling meant that it would be impossible to kill music web sites in court, leaving the industry with only one legal option: suing consumers. "That decision really threw people for a loop," says Hilary Rosen, former CEO of the RIAA. "These are highly competitive companies with highly competitive executives. There were many disagreements." Despite the dissension, "a pretty big village" in support of lawsuits against file-sharers emerged in the wake of the unexpected Morpheus ruling.

Once the green light had been given, the main challenge became minimizing negative publicity. The RIAA decided to broadcast a series of warnings about the upcoming lawsuits so that no one could claim they were unaware of the threat. In June, for instance, the group sent out millions of instant messages to Kazaa users warning them that file-trading was against the law. Days later, the Web site, which makes most of its money displaying ads to visitors, counterattacked by tinkering with its instant-messaging system. Rather than having it be offered automatically to all visitors, it became an option that users had to click a box to use—a move that cut down on the RIAA's ability to warn downloaders. Kazaa says

that it acted to save users from "potentially distressing unsolicited messages."

On June 25, the RIAA announced that it had reached the breaking point: File sharers would be sued. The next day, the industry's bloodhounds, as it were, ran off their leashes. The hunt was largely conducted by automated Net crawlers operating around the clock. While the industry is loath to reveal its investigative techniques, RIAA sources say the crawlers began by plugging in names of popular songs, such as Eminem's *Lose Yourself*, into song search engines such as Kazaa. That search, in turn, produced a list of hundreds, and often thousands, of people offering to share it.

The crawler then conducted a second "user-name" search to find out what other material these individuals were offering. Although millions of people are logged on to Kazaa and other sites at

any given time, new parallel computing techniques make it possible to analyze every member of this massive community in a matter of weeks. In many cases, firewalls can be obstacles, preventing a search by user name. But this hurdle can be overcome by cross-referencing the thousands of individual song searches, making it possible to compile evidence against pirates a hit single at a time. The final step in the process is asking Internet service providers for the surfers' identities. Most ISPs have gone along with these requests reluctantly—but they might stop entirely if legal challenges by Verizon and SBC succeed.

The RIAA did more than simply inventory what songs people are offering via the Web. It also collected the "metadata" associated with the individual tunes. For instance, many MP3 music files offered on Kazaa also list the Web site the song comes from, the name of the person offering it online, and the software used to make the files. This can be damning evidence against defendants who try to claim that all of the music on their hard

The legal campaign could serve as a model for other industries

they knew that a legal attack would hit consumers. "It's not that we weren't afraid of aggressive legal action from the RIAA," says David H. Johnson, general counsel for Warner Bros., which was the major label to approve the litigation strategy. "But the only way we thought it made sense was for us to have an attractive alternative." The process of rolling out legitimate online services turned out to be harder than expected, though. For in-

2001
The RIAA exhausted all of its legal appeals, Napster was shut down. But new peer-to-peer services, harder to shut down legally, such as Morpheus, LimeWire, and Kazaa, emerged.

OCTOBER, 2001
The industry sued Grokster and Morpheus in federal court in Los Angeles.



SUMMER, 2002
The RIAA starts to study the feasibility of suing individual downloaders.

APRIL, 2003
A federal judge rules that Grokster and Morpheus cannot be closed down.

SEPT. 8, 2003
The RIAA files lawsuits against 261 alleged copyright infringers.

drives is legally copied from their CDs.

On Sept. 8, the first suits were filed. The accused received summonses, a copy of the complaint listing the charges against them, the songs they allegedly distributed, and a two-page cover letter from law firm Mitchell Silberberg. "Copyright is not a victimless crime," says the letter sent to one defendant. "The music industry employs thousands of other people, such as CD plant workers, warehouse personnel, and record store clerks. They all depend on the

sales of recordings to make a living."

So far, the RIAA has been offering settlements in the range of \$2,000 to \$5,000, according to three lawyers who have counseled defendants. To get the suits dropped, the lawyers say, targets must sign a contract restraining them from discussing their deals. Just two days after the filing of suits, 10 people had already reached agreements.

About the only element of the campaign decided after the announcement of the legal attack was the amnesty pro-

gram—an effort to fend off a wide feared backlash. Anyone who has offered music illegally can avoid liability by signing an affidavit promising to stop downloading music. That's an effort to win compliance from the vast majority of file sharers who have not been sued—the RIAA's real target. Changing the behavior of this community is Sherman's ultimate goal. The verdict on that count, though, may not come for years.

By Mike France in Washington, and Ronald Grover in Los Angeles

A RISING CHORUS OF MUSIC DOWNLOADERS?

It is a helluva comedown. Not too long ago, the brash entrepreneurs who launched the peer-to-peer file sharing services were nearly as exalted as rock stars to a new generation of music fans. But along came the music industry with its gloves-off campaign to fight piracy. The moguls are now painting the P2Ps as nests of evildoers and even accusing them of helping to proliferate child pornography.

But P2P executives have begun to mobilize, hoping to send out the message that, despite attempts to vilify it, file-sharing is a legitimate technology. And the companies that once gloried in the anarchy of the cyberfrontier are now offering an olive branch to the music establishment by suggesting ways it could make money on peer-to-peer.

The file-sharing companies are forming a trade group to counter the powerful Recording Industry Association of America (RIAA). In late September, six companies, including Morpheus, Grokster, and Lime Wire, will introduce a Washington lobbying group called P2P United. Its first initiative will be to distance itself from charges that the file-sharing sites abet pornography. One early move: agreeing to install software that will restrict minors' access to X-rated sites.

Second, P2P is working to unify file sharers to help convince Congress that peer-to-peer technology is not a criminal enterprise. "We may not have as much money as the entertainment industry," says Michael Weiss, CEO of StreamCast Networks Inc., which owns Morpheus, "but we



P2P MOBILIZES

Under assault by the record industry, peer-to-peer, or music file-sharing, companies are banding together for a counterattack. Their strategy:

OPPOSE LEGISLATION

► The file-sharing industry is fending off bills in Congress criminalizing the downloading of copyrighted works via file-sharing.

GUARD AGAINST PORN

► P2P services say they'll install software that can help screen X-rated sites, hoping to muffle record companies' argument that file-sharing spreads pornography.

BROKEN A TRUCE

► Enter into voluntary licensing agreements with the record labels for downloading. One idea: Create a royalty pool from surcharges on the sale of blank CDs, CD burners, and MP3 players.

have something stronger—62 million Americans who use file-sharing software" to download music. A college speaking tour is being organized and a Web site created to encourage file sharers to write their lawmakers in support of peer-to-peer.

These fervent Net defenders believe, too, that history is on their side. As they see it, technology isn't the enemy. Instead, it expands the pie for everybody by opening a fresh source of music revenues. Just look

MORPHEUS' WEISS:
Rallying file-sharers in the U.S.

at the evolution of videocassettes, says Weiss, who early on, in 1978, opened a video store. Although film studios initially fought the advent of

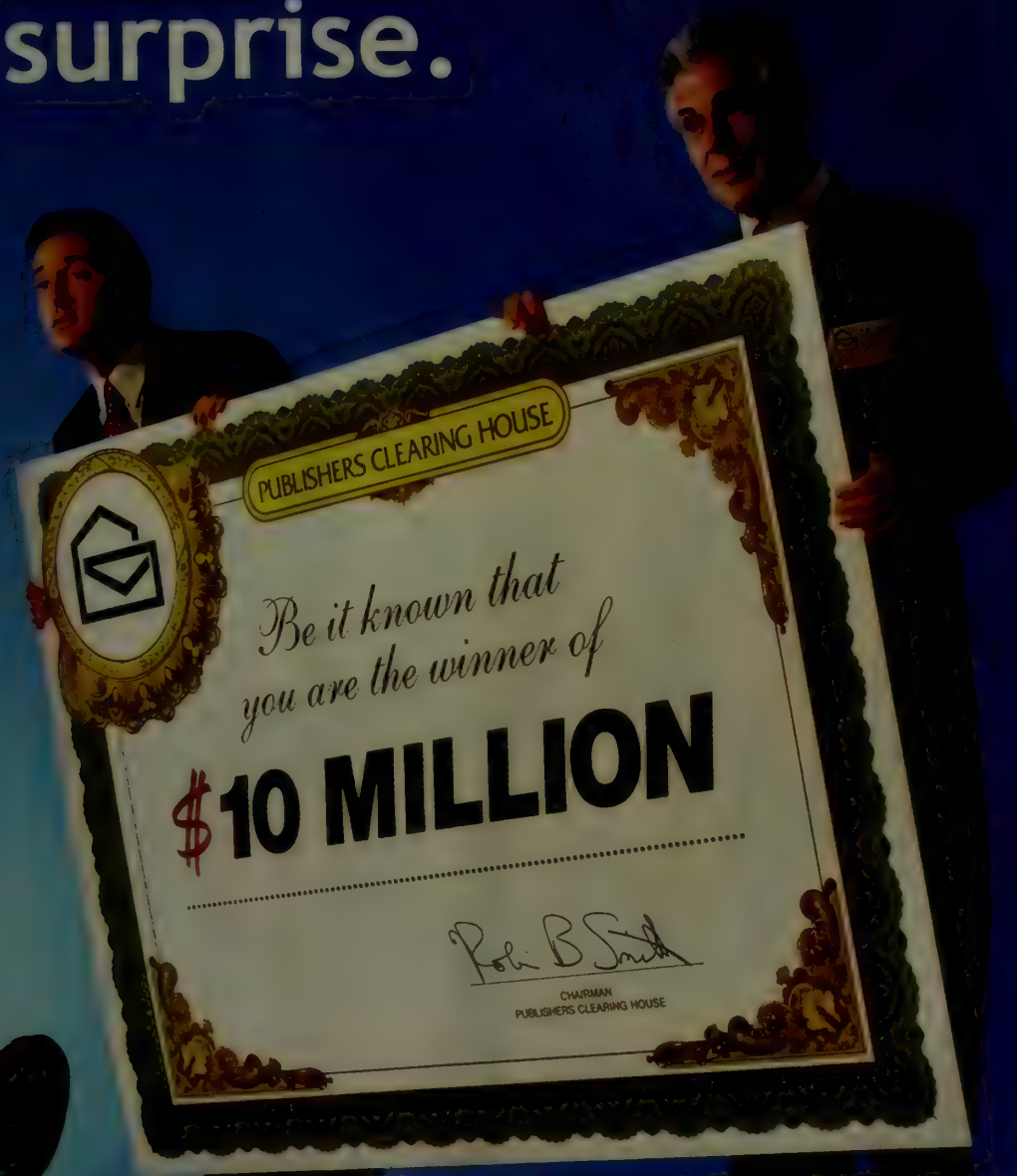
VCRs, he points out, the U.S. Supreme Court blessed the use of the new technology in a landmark 1984 ruling. Today, movie studios reap up to 50% of revenues from videotape and DVD sales. So, too, insist P2P proponents, could online distribution boost sagging music sales.

In its biggest conciliatory gesture so far, the Net group that built its following on the notion of free content is proposing ways labels can make money on peer-to-peer. One scenario: file-sharing services could volunteer to pay license fees to record companies for music downloading. P2P leaders may lobby for new surcharges on blank CDs, MP3 players, and CD burners to help create a \$3 billion annual royalty pool for the music industry. A \$5 fee on monthly broadband connections is on their wish list.

Recording-industry execs aren't thrilled about sharing the business with P2P upstarts. But longer term, insists the Internet crowd, the labels will have to put aside their lawsuits and join the march of technology—or risk losing even more customers.

By Catherine Yang in Washington

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FEEES!

Companies can't raise prices, so they're socking consumers with hundreds of hidden charges—and

FEEES!

that's creating stealth inflation and fueling a popular backlash

FEEES!

America used to be the land of the free. Now, it's the land of the fee. Companies, hard-pressed for money, are taking every possible opportunity to nickel-and-dime people to death. Need a monthly brokerage account statement mailed to you? Ameritrade may charge you \$2 per statement. Want your hotel room cleaned? The Alexander Hotel in Miami Beach, Fla., will bill you an extra \$2.50 daily for housekeeping. Have to return a new camcorder? Best Buy Co. will dock you 15% as a "restocking fee." Want to buy a season ticket for pro football? The New York Jets will make you pay \$10 for the privilege of getting on their waiting list.

The U.S. economy has become sneaky. Inflation is officially low, but Americans face an ever-growing mountain of extra charges that are pushing up the true cost of purchases. No area is safe, from retail to finance to travel to sports. "You have companies charging fees for things that were free on an unprecedented scale," says Claes G. Fornell, marketing professor at the University of Michigan Business School.

The extra hits—each one typically small by itself—add up to big money

(table, page 100). AT&T could bring in as much as \$475 million by charging its long-distance customers a new 99¢ monthly "regulatory assessment fee." Fresh fees for services such as housekeeping will generate \$100 million for hotels this year, according to PriceWaterhouseCoopers. Fees on consumers who pay bills online bring banks an estimated \$2 billion. And credit-card late-payment fees—up by 11% over the past year, on average—could reach an astonishing \$11 billion this year, estimates investment bank R.K. Hammer.

The fee frenzy is mainly an attempt by Corporate America to escape the brutal price wars of the past few years. Companies can't raise list prices without losing business, so they are burying higher charges in the fine print instead. "It's much easier to raise a price through obscure fees and surcharges than it is to raise a sales price," says Stephen Brobeck, executive director of the Consumer Federation of America.

The plethora of stealth charges

Cover Story

By Emily Thornton

It's not just Big Business. Government plays the game, too. This year

makes it much harder for consumers to use the Internet to do comparison shopping, as they started to do in the late 1990s. The result is that apparently simple buying decisions are turning into a hopeless and discouraging labyrinth. In response, frustrated consumers are fueling a backlash, including the creation of new vigilante organizations to pressure companies to roll back fees (page 104).

The growing significance of extra fees means that inflation is understated. Surprisingly, many add-on charges are not reflected in the Bureau

Cover Story

of Labor Statistics consumer price index. One reason is that many companies, especially in airlines and telecom, haven't provided the BLS with a full breakdown of their charges. In addition, fees for such things as credit-card late payments and airline-ticket changes—both rising—are not included in the government's figures. The implication: Fears of deflation may be overblown. Instead, the true rate of inflation, so important for setting monetary policy, is probably higher than the 2% or so that the BLS is reporting.

State and local governments are also willing participants in the fee game. Rather than hike taxes, politicians are hitting up Americans with a bewildering array of fees, fines, and penalties. Cash-strapped states will pull in \$2.6 billion in new revenues this year by raising more than 200 different fees on everything from fishing licenses to fingerprint processing to driving with new tires. On Aug. 15, the fine for driving without possession of a driver's license in New Jersey jumped to \$173, up from \$44. Some of the charges are ridicu-

lous: With some exceptions, blind Massachusetts residents now have to shell out \$10 once, and \$15 every five years, certification that proves they are legally blind.

Already, the new wave of consumer outrage is having serious consequences for politicians. One reason California Governor Gray Davis lost so much support was the popular outrage after he hiked car-registration fees that he had raised several years ago. They will triple this year, to an average \$234 annually, up from \$76.

Corporations are feeling the heat as well. A string of suits involving fee abuses filed by class-action lawyers, state attorneys general, and private groups like the AARP are under way. New York State Attorney General Eliot Spitzer made Sears, Roebuck & Co. and EchoStar Communications Corp. pay millions of dollars to settle claims of excessive surcharges on recycling batteries and undisclosed satellite-service termination fees. "We were not aware New York had a law capping the fee, and once we knew we changed it almost immediately," says Sears spokesman Bill Masterson. EchoStar points out that there was no finding of wrongdoing and that it settled to avoid costly litigation. And a California Superior Court judge has ordered MasterCard and Visa to refund \$800 million to customers for charging hidden fees on purchases made in foreign currencies. Visa denies the charges and is fighting the ruling. MasterCard plans to appeal the suggested restitution procedure.

There are other signs that popular dissatisfaction with fees may finally be having an impact. Fees for using ATMs have been a bane of consumers for years. On Sept. 3, Washington Mutual, one of the most aggressive retail banks in the country, stopped levying such charges on users of its ATMs in the Ne-

I GOTTA PAY WHAT?

People will pay billions of dollars more in fees this year. Here are some examples:



\$50 Billion

for banks and credit-card issuers

Nobody beats the banks and other financial services companies when it comes to adding on the fees. Banks will get **\$30 billion** this year from customers paying extra for bounced checks, using automated teller machines, and other added charges. Credit-card issuers will rake in an estimated **\$20 billion** in extra charges such as late-payment fees, which have been rising. And that doesn't even include fees that online brokers charge small-time investors.



\$40 Billion

from various legislative acts

Politicians don't like to raise taxes, so they're hiking fees instead. To close budget gaps, states levied **\$2.6 billion** in new charges this year, on top of **\$37 billion** they already collecting. The new fees include higher penalties for driving without carrying a license, court filing fees, late bar-closing fees, such absurdities as in Alaska, where anyone who wants to drive on new tires now has to pay the government \$2.50 per tire.

Data: National Conference of State Legislatures, PricewaterhouseCoopers, Saveonphone.com, companies, local officials, AFMS Transportation Management Group, UBS Warburg, Air Transport Assn., SJ Consulting Group, Consumer Federation of America, Wireless Consumers Alliance, R.K. Hamma: *BusinessWeek*

as brought in new revenues by jacking up 200 different fees

work area, even ones with accounts at other banks. Meanwhile, Congress is weighing higher disclosure requirements for mutual-fund fees for mortgage closing costs, which can be hundreds of dollars. "There are incredible fees out there," says Hous- & Urban Development Secretary Mel Martinez. Fees have long been a fact of life in some industries, such as financial services and travel. Car renters, for example, are used to having their bills inflated by extra charges, such as gas-tank refill penalties.

But the urge to raise fees has gotten out of hand. One of the worst offenders is the telecom industry, which advertises cheap wireless and long-distance calling plans and then adds on extra charges that add 20% to consumers' cell-phone bills, on average. Many wireless-service providers are charging extra to help pay for new technology to enable customers to switch companies without giving up their phone numbers. Sprint PCS, for example, is charging 18 million customers \$1.10 a month, which would amount to \$238 million annually. Sprint

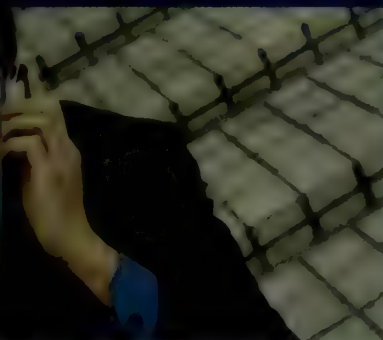


refuses to confirm or deny the total. AT&T's regulatory assessment fee, charged to its long-distance customers, covers such items as property taxes and expenses associated with regulatory proceedings.

Phone companies justify their extra fees as the only way to cover expenses without losing customers. "Sprint's recovery of these costs via the surcharges will end when these costs are recovered as permitted by law," says spokesman Dan Wilinsky. Adds AT&T spokesman Bob Nersesian: "If you're advertising a higher rate based on your expenses, and your competitors are advertising a lower rate but adding various fees at the bottom of the line, what are you supposed to do?"

Other companies use charges to weed out unprofitable customers or to change their behavior. Some airlines have recently started charging passengers \$50 for paper tickets and \$25 for every bag over 50 pounds. Ameritrade's \$2 fee for monthly statements encourages people to wait for free quarterly statements or to get updates on their accounts online. And most on-

TELECOM



\$33 Billion

Wireless, long-distance, and cable

fees. Change-of-service fees. Termination fees. Directory assistance fees. Regulatory fees. Number-portability fees. Hookup and equipment fees. Telecom and cable companies have been adding on numerous extra fees to boost revenues and cover costs. All told, fees add **20%** to the cost of wireless service, **15%** to the cost of long distance, and **10%** to cable and satellite

TRAVEL



\$17 billion

for hotels and airlines

That advertised \$200 flight could cost a lot more, once you pay airport-security fees, landing fees, and fuel surcharges. Changing your reservation could cost \$100. Some airlines now charge even for food on certain flights. Such fees bring the industry **\$16 billion**. Once you reach your destination, don't be surprised if your hotel tacks on extra for using the exercise room, accepting packages, or cleaning your room. Total hotel fee revenues: **\$1 billion**.

OTHER INDUSTRIES



Varies

More and more industries are getting in on the fee racket. Some examples: Retailers such as Target and Best Buy force shoppers to shell out **15%** of a product's price for the privilege of returning expensive electronic items. Package-delivery companies charge extra for delivery to remote areas, for customers mislabeling or using the wrong packaging, and even for the gas used by the companies' trains, trucks, and airplanes. Approximate cost to customers: **\$4 billion**.

■ Consumers are voting with their feet: Add-on charges that have no justification are increasingly driving them away

line brokerages impose an extra fee on small-time investors who do not make a minimum number of trades. E*Trade Group Inc. and TD Waterhouse introduced in 2001 "maintenance" fees on brokerage accounts. "Our customers have access to streaming quotes, a rich set of research tools," says Connie Dotson, E*Trade's chief communications officer. "If the account itself doesn't generate the revenues to offset the cost, then for that value we charge a maintenance fee."

Cover Story

Package-delivery companies such as United Parcel Service Inc. and FedEx Corp. have offset increased expenses by adding on fee after fee over the past few years. Starting in 1999, package-delivery companies charged \$1 per package for deliveries to remote areas. Now, they tack on "fuel surcharges" for the gas in the planes, trains, and trucks used to deliver packages. These fees are broken out on bills for regular customers, though not always for infrequent ones. Indeed, Airborne Inc. has listed a 25¢ charge for handwritten airbills on its Web site even though the company says it doesn't charge it. "It covers us in case we do decide to charge the fee in the future," says spokesman Robert Mintz.

In the retail sector, fees take a different form. Target Corp. and Best Buy Co. make customers pay a "restocking fee" of 15% for the privilege of returning electronics items such as camcorders, laptops, and radar detectors. Although neither Target nor Best Buy will disclose how much they earn from such fees, it's not small change for consumers. Best Buy justifies the penalty as a way to discourage people who would take the camcorder, say, and return it after using it once. Target did not return repeated calls.

So many people have asked about these restocking fees that Massachusetts' consumer-affairs department posted an alert about the practices on the Web in August. It warned that some retailers made people pay such fees even when they bought a defective product. "That's illegal," says Tatum Zuckerman, at the state's consumer hotline.

Not to be outdone, the original leader in fees, financial services, is finding new ways to raise revenue from customers. The growing

dependence of banks on fee income has spawned a new breed of consulting, such as at Houston-based Strunk & Associates which helps banks find new sources of revenue. One example: offering protection against bouncing checks, for a fee. Strunk justifies such fees as a way to improve customer service.

No one can beat the credit-card industry for its fee inventiveness. Deadlines for paying bills have been shortened to little as two weeks, and they're strictly enforced, producing more late fees. Not coincidentally, the number of credit-card delinquencies with \$35 late fees doubled last year, says Consumer Federation of America. People can avoid late fees by paying their bills over the phone or online. But some banks and credit-card companies charge for that, too. Washington Mutual charges virtually all of its customers a total of \$60 a year to pay their bills online. And it costs \$15 to pay bills at the last minute over the phone at MBNA Corp. and Provident Financial Corp. MBNA and Provident say it takes staff time to process these payments by phone and that customers can pay online for free.

It does make sense to charge a premium for added services that cost more to provide, rather than force all customers to pay the same amount, whether or not they use the extra services. Splitting out such fees helps keep basic costs low. One example: charging extra for airline food. United Airlines has been trying out making passengers on certain flights pay

\$10 for chicken sandwiches supplied by Panera Bread on Friday's and Monday's flights from Eli's Cheesecake. Northwest Airlines and US Airways Group Inc. have also started charging for food. "It's proven to be extremely popular," says US Airways spokesman David Castelvetter. "Customers have a choice."

But many fees have no such justification, and ultimately, the nagging could cost companies their customers. Consider Natalie Armstrong in Gorham, Me. She and her husband have been back at Sears only once since her husband Lester was ambushed in January by \$29 in late payment fees along with a \$1 "service charge" from a Sears credit card for a \$1 part for his saw. After he convinced one clerk that his payment was actually on time, the company hit him with \$30 more in fees. In the end, he handed over \$60 in cash to the salesperson. After being contacted by BusinessWeek,



FEE FRENZY: THE HIDDEN ECONOMIC COSTS

PRICE TRANSPARENCY Makes it difficult to compare prices on the Internet because many charges aren't reflected

CONFUSION Frustrates consumers by creating an opaque labyrinth of seemingly arbitrary charges

POLICY Creates stealth inflation, which potentially distorts economic policymaking

WASTE Diverts corporate resources into coming up with new, more complicated ways to charge fees

Data: BusinessWeek





No matter how many you took care of yesterday, there are always more today.

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nessWeek, Sears pledged to refund the late-fee charges.

Some banks are backing down after a barrage of criticism. Bank of America stopped charging customers to pay bills online last May when it discovered it could get more of their business

if it offered the service for free. Last December, Bank One Corp. ditched a \$3

charge for no-frills checking-account customers to use a branch teller when it discovered that irate customers were bolting to rivals. "Imagine if you are a retail store and your goal is to sell sweaters, and you're charging admission," says Charles W. Scharf, president and CEO of retail banking, who changed the

policy after he got his job in May, 2002. "It's counterproductive

Still, many businesses are holding firm. The New York Jets responded to fans outraged over the waiting-list fee by announcing that people lucky enough to get season tickets could deduct the \$50 they paid for waiting for them. The goal of the fee, says the Jets, is to prune the list to fans who are genuinely interested in buying tickets. "Some people aren't even alive when they're on the list," says spokesman Ron Colangelo.

Nobody figures fees will be eliminated entirely. But as the country recovers from an era of corporate scandal, it's not much to ask that companies keep prices easy to understand. That way people will know they're getting what they pay for.

With Michael Arndt in Chicago

Cover Story

HOW TO STAND UP TO THE NICKEL-AND-DIMERS

In a world of fees gone wild, what's a consumer to do? In some industries, such as banking, complaining customers can sometimes get fees rolled back. In others, such as telecom, it may be best to seek out competitors without fees. When a charge seems especially underhanded, an individual may want to join a consumer-action group.

In retail banking, consumers can get around certain fees if they're willing to give up some services. The first step is to get educated: Ask about the pricing and fee structure before signing up for a service. It may be possible, for example, to avoid checking-account fees, which can be as high as \$20 a month, by signing up for direct deposit or forgoing the return of canceled checks.

But don't stop there. Given industry competition, banks are often willing to reduce other fees when faced with a determined customer. Call to question unreasonable or inflated charges. "In a marketplace where prices are increasingly negotiable, complaining consumers have a fair chance of persuading sellers to reduce or eliminate individual fees," says Stephen Brobeck, executive director of the Consumer Federation of America.

Credit-card companies often will waive late fees for longtime cardholders in good standing when requested. You also have some clout when it comes to annual credit-card fees: Call the company and ask about the costs of other cards it offers. You

may get a better deal by switching.

An effective option, of course, is to change companies when dissatisfied with fees. "The most successful consumers are the ones willing to walk away," says Matthew Smith, founder of complaints.com, an online database of consumer gripes. Major long-distance phone carriers AT&T, Sprint,

and report any fee increases to the site. If the phone companies have violated any regulations, the site will alert the appropriate agencies. Consumers can also earn up to \$20 if they are the first to report a rate or fee increase not already listed on the site.

Two more general Web sites, rip-offreport.com and complaints.com,

give consumers a place to report and vent their frustrations with companies that charge excessive fees.

Finally, outraged individuals can look for help from consumer groups such as Consumers Union or the U.S. Public Interest Research Group. These knowledgeable, politically savvy organizations know how to effect change. Consumers Union, for example, took on Barnes & Noble Inc. and Blockbuster Inc. for the

monthly service fees they charged on unused balances on electronic gift cards and certificates. "It's your money; you [or someone] paid

in advance, so you shouldn't have to pay a fee," argues Gail K. Hillebrand, an attorney at Consumers Union in San Francisco. The group helped get a law passed in California in July that bans nearly all fees on gift cards and certificates.

Such action may well become more common as frustration with fees grows. If it does, corporations might back off from nickel-and-diming those they are supposed to serve.

By Toddi Gutner in New York

FED UP WITH FEES?

Five steps to fight back:

Data: BusinessWeek

3 Switch companies if your complaint isn't met with a rollback of fees.

1 Call the company's customer-service number and speak with a supervisor. Ask for a description of the company policy.

4 If a fee seems particularly unfair, send a complaint to the attorney general, who may sue if there are enough complaints.

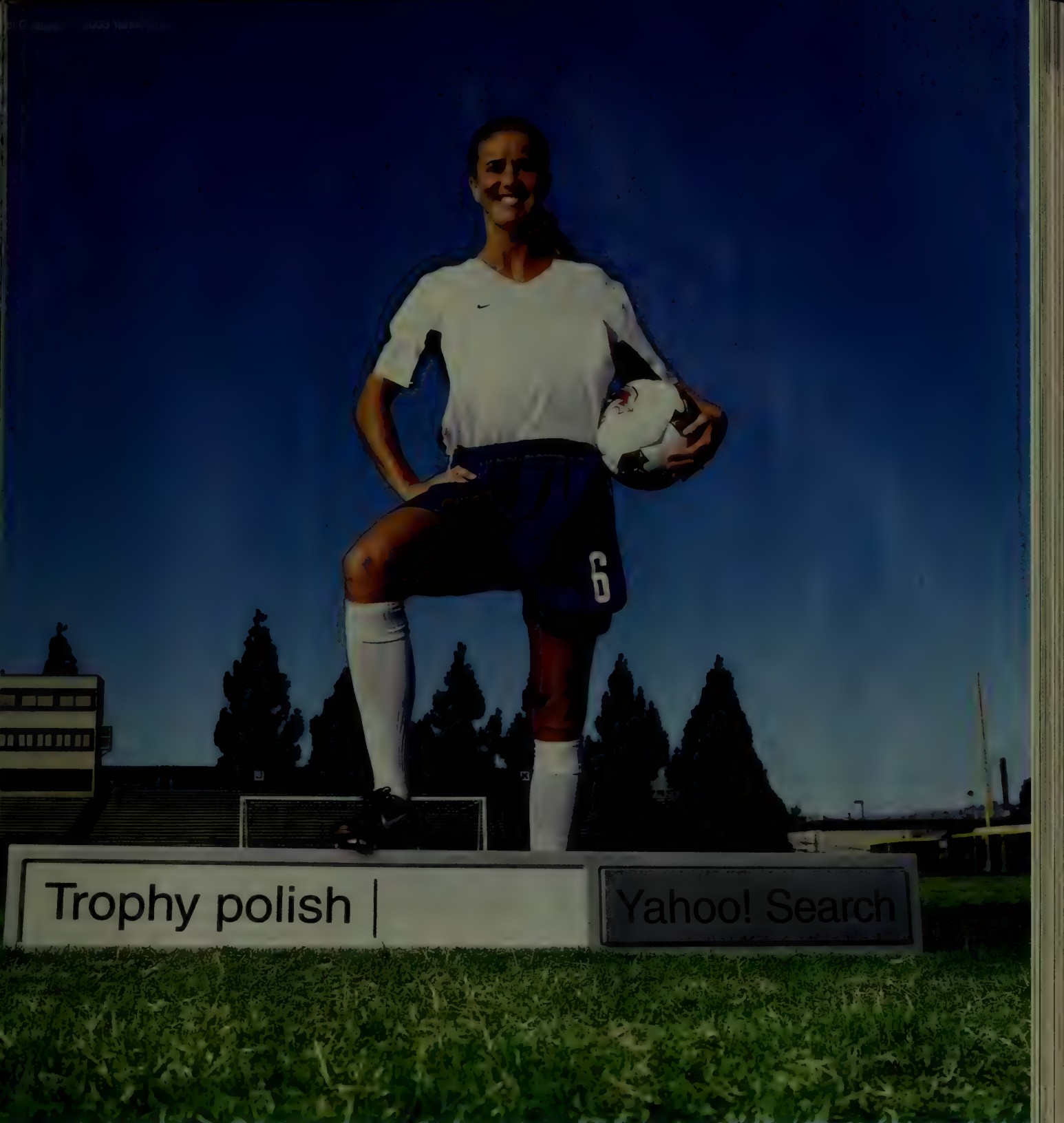
2 Complain to the supervisor if you're still dissatisfied. Keep good notes on whom you speak with and when. Be persistent.

5 Join forces with organized groups such as Consumers Union or U.S. PIRG.



and MCI introduced new fees this summer and may be faced with a customer exodus once people discover that low-priced long-distance carriers such as TCI and ZoneLD are just as good—and they "don't have the same fees," says Bill Hardekopf, CEO of SaveOnPhone.com, a consumer Web site.

SaveOnPhone.com is one of the many vigilantes that have popped up all over the Web to police extra charges. This site helps consumers shop for cheap long-distance service by comparing carrier plans, providing a rate calculator, and offering consumer tips. Phone-bill-alert.com asks consumers to watch their phone bill



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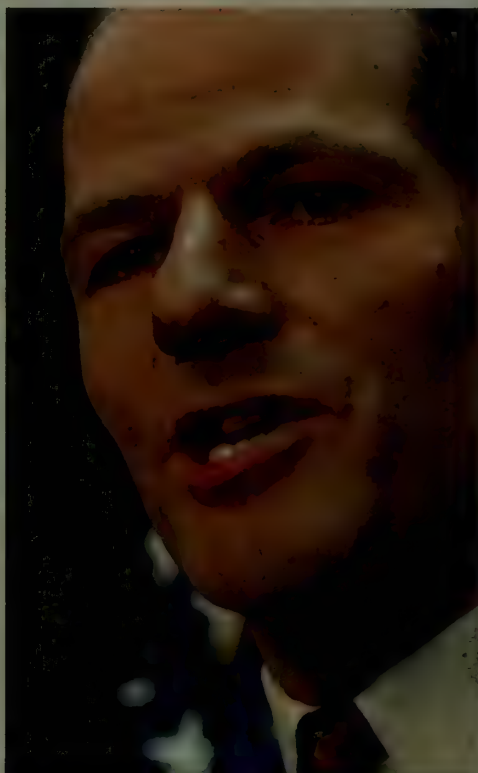
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FINANCIAL SERVICES

STATES VS. THE FEDS: A FRAGILE TRUCE

In policing money pros, a tug-of-war over who's in charge



on big corporate icons on behalf of consumers. And the public perception that the states are cracking down on shady practices more aggressively than the feds is turning up the heat on Washington. Banks and brokerage firms that operate nationally are up in arms about the prospect of a patchwork of rules. But the uniform standards they support are generally less rigorous than what state officials and consumer advocates say is needed to deter abuse.

The outcome of these battles would be clearer if Congress could make its mind where it stands. While conservatives on Capitol Hill traditionally favor states' rights, Congress has been sympathetic to pleas from financial-services firms—among the biggest campaign contributors—for one set of national rules. So the feds are squashing state efforts to force national banks to follow

TURF WAR

Donaldson (left) insists the SEC is the markets' rule-setter. New York AG Spitzer seeks tougher enforcement

local predatory lending laws. But the states have a reputation for being shot at enforcing their own rules on issues where Washington has left the door open to local solutions.

Privacy is where states may have the most running room.

A new California law lets consumers block banks, credit-card companies, and other institutions from sharing their personal financial information. The law clashes with provisions of the Federal Credit Reporting Act that overrides state curbs on sharing customer data by companies under the same corporate umbrella. The provisions expire on Jan. 1, but the House on Sept. 10 voted 394-30 to make them permanent. A rival Senate bill would let consumers block solicitations from affiliated companies but still allow them to share data. "That's only half a loaf," complains Democratic California State Senator Jack Speier, sponsor of her state's law.

If the federal act's provisions are renewed, the courts could overturn part of the California law. But that law will still impose curbs on data-sharing with outside firms that are stricter than the

New York Attorney General Eliot Spitzer isn't the only state official at odds with Washington these days. Spitzer recently upstaged the Securities & Exchange Commission with a headline-grabbing \$40 million settlement with a hedge fund for improper trading of mutual-fund shares. But turf fights are raging all along the financial-policy front. The states insist they have the right to impose their own, stiffer rules on national financial institutions to protect consumers' privacy, curb predatory lending, and police brokerage firms. The

feds' response? Back off—that's our job.

Chalk up the tug-of-war in part to a backlash against what's popularly seen as the feds' frequent ineptness as enforcers. With rising complaints about privacy abuses, deceptive lending practices, and other rip-offs, states are moving into the vacuum created by Washington's inattention "to the ways that the changing financial-services market is harming consumers," says Travis Plunkett, legislative director for the Consumer Federation of America.

Spitzer's attacks on Wall Street are inspiring other state enforcers to take

WHERE THE ACTION IS

A battle over regulating financial services is playing out on several fronts

PRIVACY

▶ A tough new California law lets consumers block the sale of personal financial information by banks, credit-card companies, and others. The measure clashes with federal rules.

WALL STREET

▶ State and federal securities cops are tripping over each other's investigations and vying to set rules.

al code. Alarmed, financial firms eating the drum for a national standard. But to get one, they'll probably have to give consumers more protections than federal law does now. In the investment-fraud beat, state securities regulators are looking to patrol more territory. They have been able to kill a congressional proposal to bar them from imposing their own rules on brokerage firms that violate securities laws. State securities cops also have agreed to a truce with the SEC over trading Wall Street. In a show of cooperation on Sept. 16, Spitzer and SEC Enforcement Div. Director Stephen M. Lipp jointly announced charges against Bank of America broker in connection with the mutual-funds case. Still, teamwork could easily break down, as SEC Chairman William H. Donaldson's insistence on his agency's role as markets' rule-setter—and the AG's' penchant for publicity.

The states aren't making much headway, though, in imposing their own laws on national banks. With some lenders targeting low-income borrowers for high-rate mortgages, states such as Georgia and North Carolina are adopting laws against predatory lending. But lately, the federal Office of the Comptroller of the Currency said Georgia's law—barring fat fees, prepayment penalties, and other abusive loan practices—doesn't apply to national banks, which the OCC oversees. The state backed off on applying the law to these banks. "No matter how beneficial the law, constitutionally, states don't have the power to regulate the activities of federally created financial institutions," says Comptroller of the Currency John D. Hawke Jr. States know their laws can be preempted but pass them anyway because it's politically popular, he says. Besides, Hawke insists, the real culprits are not national banks but mortgage brokers and finance companies, which the law still covers.

The turf battles over financial policy are heating new. The states and the feds have sparred since the days of Alexander Hamilton. At a time of nonstop revelations of shady practices by financial institutions, the current fight could last a few more rounds yet.

By Amy Borrus, with Mike McNamee, in Washington

PREDATORY LENDING

Georgia, North Carolina, and other states have passed laws that bar lenders from terms such as high fees on subprime loans. The feds say national banks are exempt from these laws.



VENTURE CAPITAL

ALL CASHED UP WITH NO PLACE TO GO

VCs have \$84 billion to invest and an aversion to risky startups

The venture-capital industry is facing an embarrassment of riches. Venture firms have a staggering \$84 billion in their coffers to invest, a near-record amount. And institutional investors are eager to give them more dough, anticipating that the tech industry will regain its financial luster. The signs are promising: Technology stocks are on the rise, and a handful of tech companies, including FormFactor Inc. and Netgear Inc., have gone public recently. "Even today, after all the problems the business is having, there are tons of institutional investors clamoring to get into the venture business," says Joshua Lerner, a professor at Harvard Business School. "This is what we call the potential overhang."

But the flood of money could turn out to be more bane than boom. For starters, the seemingly endless supply of resources could lead venture capital firms to throw good money after bad, keeping alive faltering companies instead of shutting them down. VCs also are chasing bigger and bigger deals, putting increasing amounts into later-stage projects and even leveraged buyouts. These investments may use up big chunks of capital, but they hardly fit the high-risk profile for which venture firms are traditionally known.

Indeed, venture capital firms seem more risk-averse than ever when it comes to backing new tech companies. Just 21% of all venture deals done in the 18 months through June were in

A HANGOVER THAT WON'T GO AWAY

Though the money's pouring in, venture capitalists have plenty of headaches

early-stage investments, according to Thomson Venture Economics. That's the lowest percentage since 1977, and it's way below the average 34% of the past three decades. When the VCs do make investments, they tend to be concentrated in a handful of favored industries, driving up the valuation of deals. All this could hurt the long-term performance of the industry. "The venture-capital industry is still going through dramatic restructuring," says Jesse Reyes, a vice-president at Thomson Venture Economics. "If it takes until 2007 before all the pain is washed out, I wouldn't be surprised."

Certainly, the returns that VCs are reporting to their investors these days are plenty painful. One-year returns sank to -29% as of Mar. 31, while three-year annualized returns were -17%, says Thomson Venture Economics. This for an industry that averaged annual returns of 16.6% over the past 20 years.

Still, too much caution could be costly. If the VCs focus their time and money on later-stage deals, they may not have the resources for big, new ideas. Experts say some of the most innovative, swing-for-the-fences business plans could suffer significant delays or, worse, never get off the ground. "In certain periods things have gotten so bad that even really good things are not financed," says Harvard's Lerner, referring to the mid-1970s, when the number of venture-backed startups plunged. "If things get worse, we have grounds to be really worried."

Case in point: ThinkingVOICE Networks. The Mountain View (Calif.) telephony startup has technology designed to improve customer service by

POOR RETURNS

VC funds have lost money for three years. That could continue as VCs struggle to breathe life into mediocre investments made during the bubble.

DEAL INFLATION

The VC industry has a pile of money left over from the tech boom. That might be trouble if too much money winds up chasing too few good startups.

INNOVATION SLIDE

Burned in the '90s and desperate for higher returns, VCs are shying away from risky early-stage investments in favor of larger, later-stage deals.

SHAKEOUT

Many of the vent firms that entered the fray during the tech heyday might close up shop as the 10-year cycle of their funds winds down.

more easily linking up buyers and sellers over the Internet. The company's founder, Don Christopher Cullinane, is a successful, experienced entrepreneur. He sold his last company in 1999 for \$130 million. Despite his track record and a promising idea, Cullinane can't get VC backing for his brainchild yet. So he has bootstrapped the project himself, aiming to prove his concept before going back to the VCs. Sellers on eBay are using his product, but he has scaled back his plans for ThinkingVOICE, focusing on niche markets instead of broader applications. "We've taken what was originally a very big concept and throttled it back," says Cullinane.

The more frugal nature of VCs isn't necessarily a bad thing. And just because VCs are more skittish about riskier investments doesn't mean some early-stage deals aren't getting the green light. Some \$1.6 billion has gone into such deals so far this year, putting the industry on its 1995 pace.

Much of that money is chasing the few choicest deals. New VC investments have been concentrated in just a few sectors, such as wireless networks, security software, and storage, that look like potential winners. One of the lucky few: RFco, a Los Gatos (Calif.) startup that raised \$17 million earlier this year in little more than 30 days. RFco is devel-

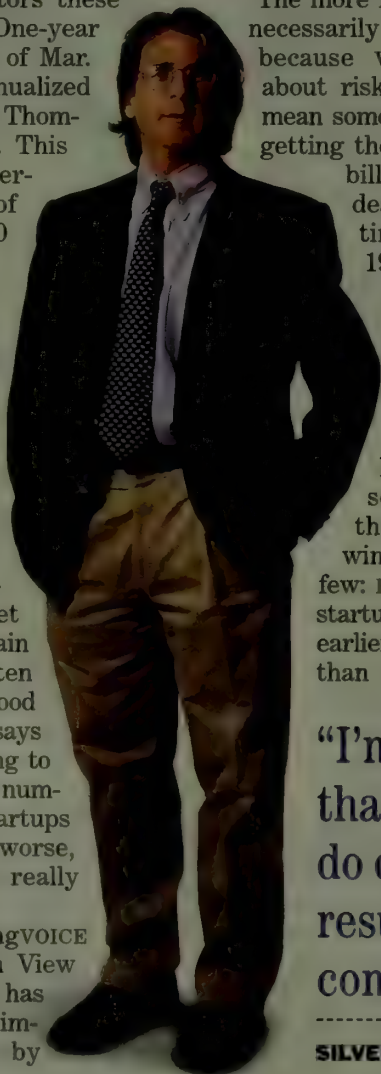
oping chips for the wireless market among other things, would allow phones to tap into any available wire frequency and considerably improve performance. It could have raised more money because many VCs consider its technology highly promising. "The first new thing in radio in 85 years," boasts RFco's CEO, Richard Forte, could have raised four times the money.

With so much money focused on a few areas of technology, some question whether a new bubble is forming. "I'm nervous that this will result in mindless competition," warns Roger McNamee, a veteran tech investor with Silver Lake Partners, a high-tech buyout fund in Silicon Valley. "The mismatch of capital and opportunity is a real threat."

There is evidence that startup valuations are starting to rise. IronPort Systems Inc., an upstart in San Bruno, Calif., that provides filtering and security technology for e-mail systems, saw its valuation nearly double within a year, from \$16.5 million in June, 2002, to \$31.5 million in July. Whether or not such an increase is merited won't be known until the company either goes public or is acquired. But critics say that it's an example of how the pressure VCs are under to invest is driving up prices. "When VCs find a good deal they're willing to pay up for it," says Bondurant French, CEO of Adams Street Partners in Chicago, a large institutional investor. "We see companies where we think the right price is \$42 million and it gets done at \$55 million."

For companies such as RFco and IronPort, that's good news. But for the venture industry at large, it may be another symptom of the lingering hangover. That's quite a price to pay for what was the greatest boom in venture history. "The venture industry may be out of the hospital, but it's still in rehab," says Jonathan D. Feiber, a partner at Silicon Valley's Mohr Davidow Ventures. And it looks like it may be there for some time to come.

*By Linda Himelstein
in San Mateo, Calif.*



"I'm nervous that [pressure to do deals] will result in mindless competition"

SILVER LAKE'S MCNAMEE

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"Integration key to CRM success" eWEEK, May 12, 2003

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COMMENTARY

By Timothy J. Mullaney

THIS IPO DOESN'T DESERVE TO FLY

Three years after the dot-com bust, companies with loopy business models should not be going public. That may seem obvious, but the Aug. 28 initial public offering filing by online travel agency Orbitz Inc. makes it clear the point hasn't gotten through to everyone. It's bad enough that Orbitz, despite being on pace to sell \$3 billion in travel this year, doesn't make money—it lost \$5.3 million in the first half of 2003 on revenue of \$107 million. It's worse that Orbitz' revenues are growing only a little more than half as fast as those of rival and segment leader Expedia Inc. Investors should avoid this deal, and Orbitz should pull it.

Orbitz' worst problem is straightforward: The five big airlines that own it, and will control its board even after an IPO, have forced Orbitz to underprice its services to subsidize themselves. And it's going to get worse. Commissions, mostly from owners United Airlines, American, Continental, Northwest Airlines, and Delta Air Lines, provide 21% of Orbitz' revenue, among the biggest line items in its budget. But under the deal that created Orbitz, commission

rates fall 27% in 2004, 28% in 2005, and 30% in 2006. That means the work that earns Orbitz a buck in commissions this year will get it about 37¢ in three years. Other online agencies don't disclose their airline deals, but they're known to take incentive payments for directing consumers to specific airlines. Orbitz doesn't. Why not? Because airlines hate paying those incentives. And the only top online agency willing to negotiate them away has been—what do you know?—Orbitz.

Orbitz has been too slow to figure out how to replace its commissions. For other travel Web sites, the big money is in merchant hotel sales and vacation packages. In both, travel agencies buy rooms and/or air tickets from suppliers, mark them up around 25%, and sell them at a profit. It beats the heck out of selling airline tickets for 3% or 4% commissions.

CEO KATZ: Head of a first-rate team that could fly high if the airlines turned Orbitz loose

Expedia gets 61% of revenue from merchant hotels and packages. Orbitz gets less than 15% of revenue from the same sources. Why? Orbitz CEO Jeffrey G. Katz has said lowering the cost of airline bookings is higher priority. Sure—for airlines.

Orbitz hopes to build a long-term advantage around the technology connecting its site directly to airline reservation systems. Dubbed "Supplier Link," it promises to cut out such middlemen as Sabre, Worldspan, and Cendant's Galileo International. The middlemen charge about \$13 per round trip. Meanwhile Orbitz charges airlines a comparatively paltry \$4 a ticket for the service. That saves the airlines \$9 a shot.

Once again, that's great for the airlines—and lousy for Orbitz, which eked out just \$4 million in first-half revenue from Supplier Link. And even though no other online agency has the technology, Orbitz set the price of Supplier Link low to favor the carriers. It makes you wonder: If Orbitz really set up to make money? And for whom?

The solution for Orbitz is obvious: The airlines should cut it loose and let it compete on an equal footing with its online rivals. Once it's not dominated by airlines, Orbitz will have a chance to thrive, cutting better carrier deals, focusing on the more lucrative hotel and package-tour business, and competing to please customers, not suppliers. Orbitz' technology is first-rate. Its management team is a lot brighter than the ideas Orbitz' ownership makes them defend. And Orbitz would still help airlines by competing with Expedia, whose market

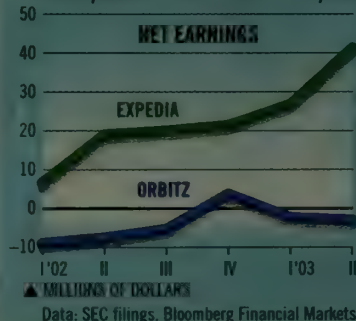
power threatens airline and hotel margins. When you take a company public, you promise investors that you will fight to make them money. Orbitz isn't built for that. Until it is, this IPO should stay grounded.

Mullaney covers online travel from New York.

ORBITZ

SLOW LIFTOFF

The airline-owned travel site is losing out to independent rivals such as Expedia



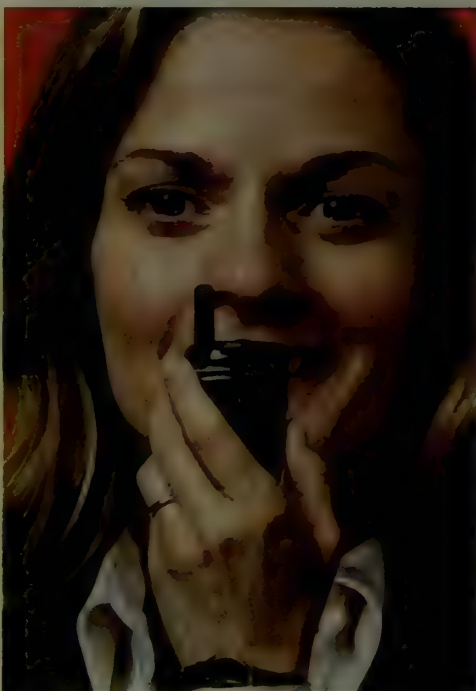
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Workplace

LABOR

STORMING THE IVORY TOWER

Why can't Yale learn how to make labor peace?

Given the tough economy, you might think Yale University would have sailed through labor talks with its clerical and service employees this year. After all, the prestigious Ivy League university didn't touch its virtually free health insurance at a time when employers everywhere are pushing more of the burden onto workers. Yale also offered annual pay hikes of up to 4% over six years—better than deals gratefully accepted this year by the more powerful United Auto Workers and plenty of other unions.

So what's the hang-up in New Haven, where since late August 4,000 members of the Hotel Employees & Restaurant Employees (HERE) union have been on strike, the ninth since 1968? Part of the problem lies with employees' poverty-level pensions, which average \$621 a month. And workers are trying to make up for what they consider a lousy deal in the last contract—2.5% annual pay hikes in 1996, even as the economy boomed and their counterparts at Harvard University and other elite colleges scored big gains.

But another, less tangible strain is mounting class and gender tension between an elite employer and its low-skilled, \$32,000-a-year workforce. The problem, says Harvard University Economics Professor Lawrence Katz, who chaired a Harvard committee to exam-



ine treatment of its low-wage employees, is that economic trends have been kind to intellectuals, but cruel to service workers. "These growing inequities are only reinforced when you have a tradition of poor labor relations" as do Yale, he says.

In broad terms, the labor strife at Yale is similar to that at other elite colleges where lower-level staff have unionized. Harvard fiercely resisted unionization by its clerical workers for 17 years and fought a nasty dispute with its janitors in 2001 that eased only after the university made peace—and dished out big pay hikes—to resolve a divisive split. Similar battles have been played out with unionizing graduate students and teaching assistants—another Yale issue—at Columbia University, New York University, the University of Pennsylvania, and the University of Cal-

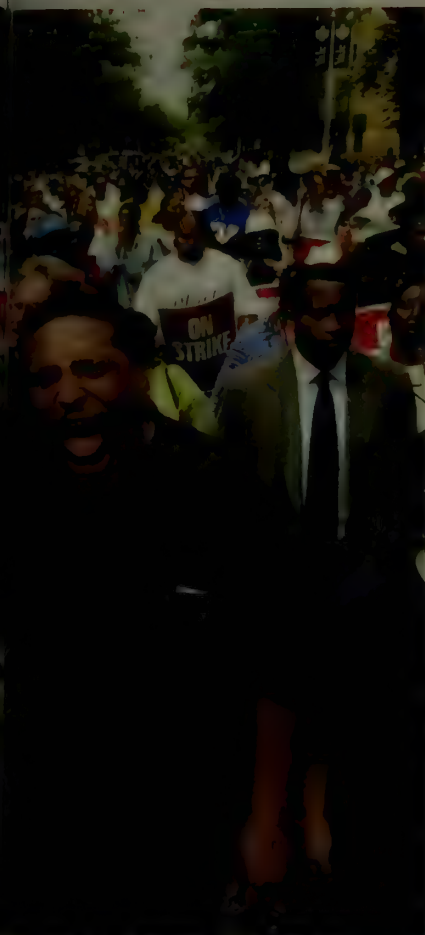
Yale's Troubled Labor History

1968 University's food-service workers mount first strike after Yale adopts tougher labor policies

1983 Clerical workers form union despite stiff opposition from Yale; mount 10-week strike in 1984

1996 Union gives in after two month-long strikes, accepts subcontracting and 2.5% annual pay hikes

2003 Still angry, union members want to make up lost ground, reject 3% and 4% annual wage increases



nia, which is girding for a showdown when contracts covering 11,000 unionized graduate students at eight campuses expire on Sept. 30.

The bitterness at Yale, though, has been festering for decades. It was so bad after months-long '96 strikes, when the university for the

first time canceled strikers' health coverage and replaced some workers with temps, that President Richard C. Levin last year brought in John R. Stepp, a former Reagan Administration Labor Dept. official, to help improve morale. Stepp's firm, Restructuring Associates Inc., worked with both sides for months and interviewed more than 100 Yale officials and union members. In his recommendations, Stepp blasted the union for defending poor performers but came down much harder on Yale for disrespecting its workers. "A university that prides itself on developing critical thinking... could reap tremendous benefits from managing its own employees as if they were capable of independent thought," he wrote.

Stepp's firm was let go a few months later, and the two sides quickly reverted to the old animosity, resulting in the current strike. The parties can't even agree on why the reconciliation effort

collapsed. Levin insists that the union walked away; HERE President John W. Wilhelm counters that Yale fired Stepp. Stepp says he stayed on until the non-economic issues were resolved but couldn't get both sides to agree to use his firm to deal with the tough economic ones. "Yale stopped bargaining after they dumped him," charges Wilhelm, who's a Yale graduate himself. "It just put out an offer 15 months ago and hasn't substantially changed it since."

Levin insists that Yale's offer will bring union wages and pensions in line with similar Harvard employees. He sees HERE as cynically playing off Yale's prestige to push the unionization of clerical workers. "It was clear in 1996 and in the past two years... that the union is focused on using Yale as a platform to advance its national agenda," says Levin. Indeed, Reverend Jesse Jackson was arrested on behalf of strikers at a Sept. 1 rally in New Haven; on Sept. 13 AFL-CIO President John J. Sweeney and three union presidents also were arrested.

HERE's high-profile tactics are winning some prominent supporters. Thousands have rallied in the community, where Yale has become the largest employer after the loss of most blue-collar factory jobs. Dozens of local luminaries

NO HAVEN
Yale workers and allies say times have hit low-skilled employees toughest

signed a letter to Levin on the union's behalf, including clergy members, Yale graduate and Presidential contender Senator Joseph I. Lieberman (D-Conn.), most of the state legislature, New Haven's mayor, and even the police chief. Still, many professors and students are losing patience.

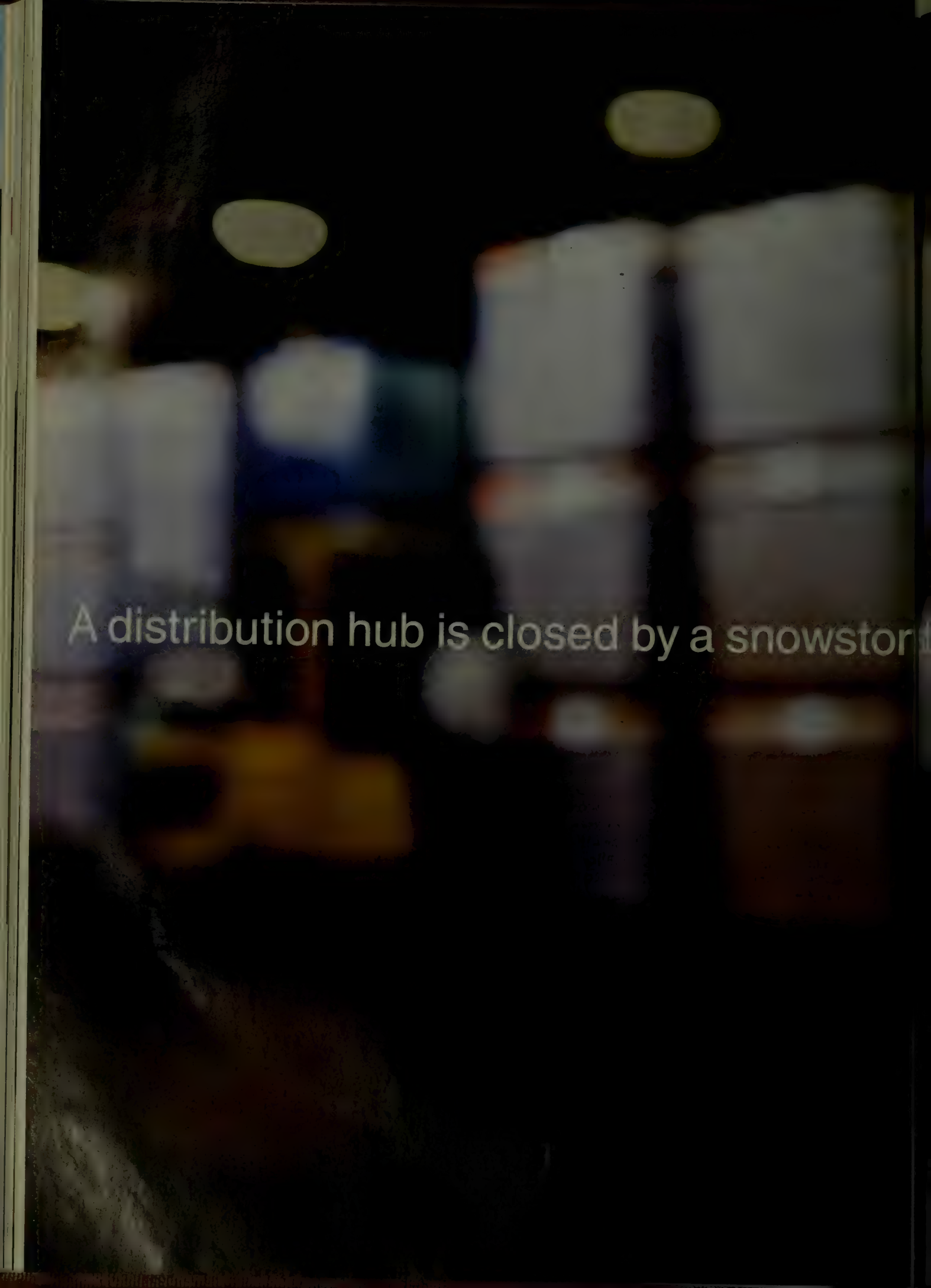
Levin may want to consult with his Harvard counterparts when it comes to handling the dichotomies of a rich non-profit institution—Yale has an \$11 billion endowment—employing lower-wage workers. During the 2001 sit-in, Neil Rudenstine, then Harvard's president, eased tensions by setting up a committee, headed by Katz, to look into employees' demands. Harvard not only adopted the findings, lifting wages and limiting the use of subcontractors, but has followed up with yearly progress reports. It also has offered more education for low-wage staff and an office to deal with their complaints. It's not so different from what auto makers and other unionized employers do to maintain labor peace. If Yale and others can't learn how to live with a unionized staff, they're likely to see picket signs popping up again and again.

By Aaron Bernstein in Washington and William C. Symonds in Boston



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THE COMEBACK KIDS

E-biz has returned with a vengeance. Meet the 25 men and women who got things clicking

What a comeback for e-business. Few would have predicted this in the dark days of 2000, when many people started to lose faith in the promise of the Internet—and even to doubt the payoff from technology itself. Yet take a look around, and you'll see that e-business has become a pillar of the economy. Consumers are more avid than ever to go places where only the Web can take them, and the corporations making the smartest use of the Internet outclass their brethren when it comes to operating nimbly and efficiently. Investors get it: The Dow Jones Internet index is up 119% in the past year, compared with just 18% for the Standard & Poor's 500-stock index.

Who's behind this amazing turnaround? Those on this year's *BusinessWeek* e-business 25 list. Because of their vision, tenacity, new ideas, and ability to deliver on promises, what was discredited has gained credibility again.

Some of these standouts have delivered on their original

business plans. Take Jeffrey P. Bezos. The CEO of Web retailer Amazon.com Inc. was chained to Wall Street's doghouse briefly in 2000 when doomsters predicted that he would soon run out of cash. Didn't happen. Analysts expect Amazon to make a profit this year on \$4.8 billion in sales.

There's plenty of fresh thinking going on, too. Literally. John J. Fedele, CEO of New York online grocery startup FreshDirect, learned from the meltdown of Webvan. Instead of offering home delivery at supermarket prices, he's delivering high-quality products at lower prices. That's clicking with finicky Manhattan shoppers. Further out there, futurist Howard Rheingold is exploring the concept of "smart mobs" to show how people will use the Internet in powerful ways. These ad-hoc groups form on the fly, by using mobile Net connections for everything from political action, and art events.

A few years ago, many people thought the proponents of e-commerce had lost their bearings. Some had. But not these men and women. They're lighting the path ahead.

EMPIRE BUILDERS P.118

Meg Whitman
eBay

Jeff Bezos
Amazon.com

Terry Semel
Yahoo!

Barry Diller
InterActiveCorp

Eric Schmidt
Google

ARCHITECTS P.119

Sean Maloney
Intel

John Thompson
Symantec

Sam Palmisano
IBM

Michael Moritz
Sequoia Capital

Ivan Seidenberg
Verizon

INNOVATORS P.120

Sanjay Sarma
MIT's
Audiold Center

Steve Jobs
Apple

Marc Benioff
Salesforce.com

Jorma Ollila
Nokia

WEB SMART P.122

Linda Dillman
Wal-Mart Stores

Michael Dell
Dell

David Neeleman
JetBlue

VISIONARIES P.124

Howard Rheingold
Author of
Smart Mobs

John Arquilla
U.S. Navy

Erik Brynjolfsson
Massachusetts
Institute of
Technology

Ken Kutaragi
Sony

UP-AND-COMERS P.126

Mark Goldston
United Online

Jim Ramo
Movielink

Charles Zhang
Sohu.com

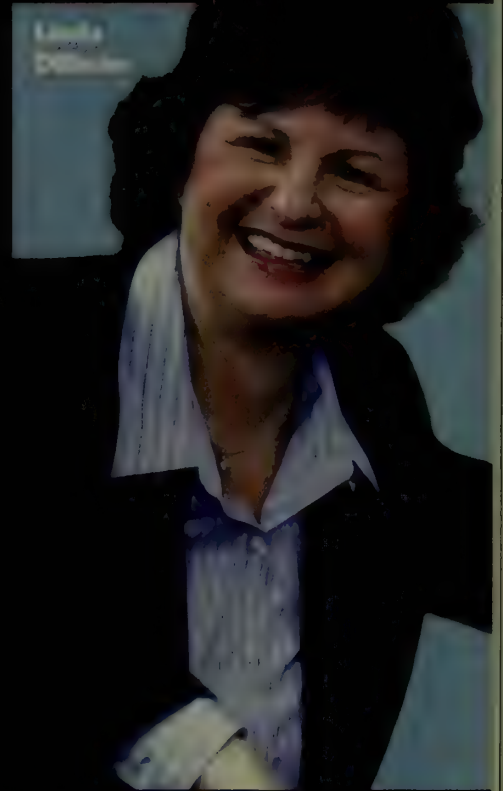
Joe Fedele
FreshDirect



Sean
Maloney



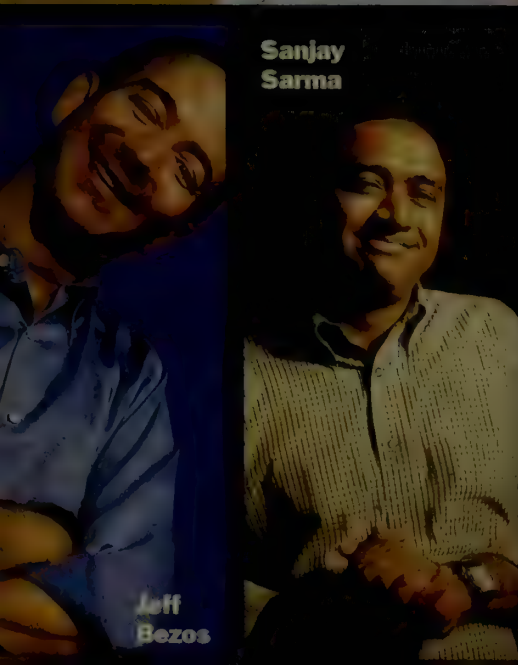
Steve
Jobs



Linda
Dillon



Mark
Goldston



Jeff
Bezos



Sanjay
Sarma



John
Thompson

Empire Builders

MEG WHITMAN eBay

You know you've arrived when Weird Al Yankovic writes a song about you. The parody singer's new ditty, in which he croons about all the stuff he bought on eBay, doesn't mention eBay Chief Executive Margaret C. Whitman. But more than anyone else, she can take credit for transforming eBay from a scruffy online flea market into a commercial blockbuster known the world over.

eBay started with a great idea, one of the few utterly true to the power of the Internet: Forget all the inventory and warehouses. Instead, simply create an online marketplace where people find and list their own products to sell. But it's Whitman, 47, whose savvy shepherding of that people power has transformed eBay into nothing less than a virtual, self-regulating global economy. This year, it's expected to top \$20 billion in sales of everything from BMWs to industrial lathes, from the U.S. to Germany, Korea, and Brazil.

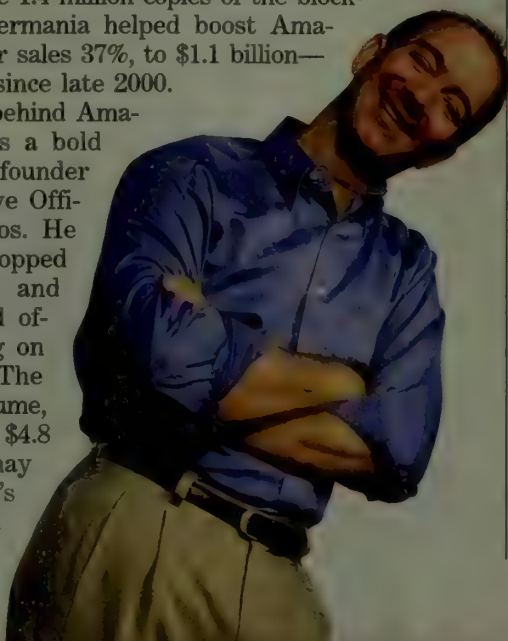
Despite her stints at such blue chips as Procter & Gamble, Walt Disney, and Hasbro, the unassuming CEO and fly-fishing fan embraced eBay's unique community of 30 million active users from the time she joined in early 1998. Says Whitman, a big eBay seller herself: "We simply try to make it easy and transparent, lay out a few rules, and get the heck out of the way." As the Net increasingly opens up other corporations' inner workings to customers and partners, they will be forced to follow eBay's lead.

eBay's users aren't done, either. Now they're helping Whitman chip away at friction points, from payments to shipping. Last year, for instance, after users essentially voted with their clicks, eBay bought payment processor PayPal Inc. and dumped its own lagging unit, Billpoint, speeding billing and merchandise deliveries. The ultimate goal: Make eBay as mainstream as shopping at the mall. If she can do that, Meg Whitman may deserve a song all her own.

JEFF BEZOS Amazon.com

For Amazon.com Inc., the June 21 release of *Harry Potter & the Order of the Phoenix* was its biggest challenge of the year. Yet it went off without a hitch, as the No. 1 e-tailer shipped in a single day some 1.4 million copies of the blockbuster novel. Pottermania helped boost Amazon's second-quarter sales 37%, to \$1.1 billion—its fastest growth since late 2000.

The real magic behind Amazon's resurgence is a bold bet by 39-year-old founder and Chief Executive Officer Jeffrey P. Bezos. He has relentlessly dropped prices on books and other products and offered free shipping on orders over \$25. The recharged sales volume, expected to reach \$4.8 billion this year, may produce Amazon's first annual profit. After all the



doubts, Bezos has proved his empire has staying power.

And he's not limiting himself to selling Amazon's own goods. Bezos recently formed a unit to help more retailers sell to Amazon's 33 million customers, as the likes of Target and Toys 'R' Us already do. Some 19% of items sold on Amazon, in fact, are from other sellers. Says Bezos: "We know how to develop world-class technology to make the customer experience in e-commerce really good." If he can persuade enough merchants to join Amazon, it may finally live up to its name.

TERRY SEMEL Yahoo!

When former Warner Bros. co-CEO Terry S. Semel came to Silicon Valley in 2001 to interview for the top job at Yahoo! Inc., he was the consummate outsider. Even the geography was baffling. After dining at the Atherton (Calif.) home of Yahoo! director Edward Kozel, the movie mogul steered his car into the inky night and quickly lost his way. After driving in circles for 15 minutes, Semel whipped out his cell phone and called a Hollywood buddy familiar with the Valley who helped him locate the main road.

Now, Semel is showing the rest of the dot-com world a thing or two about navigation. Foremost, Semel's dealmaking skills have rejuvenated Yahoo's ad business with forays in high-speed Net access and online job listings. Moreover, Semel has demanded that Yahoo's myriad Internet services interact increasingly with one another. Instead of Yahoo being an impartial tour guide to the Web—like, say, rival Google Inc.—Semel has instilled a theme-park mentality, where customers are encouraged to stay inside Yahoo's walls as long as possible. Revenues and profits have surged to record highs, and the company's stock has hit \$35, more than double its value on Semel's arrival. Investors are saying "Yahoo!" again.



Barry Diller InterActiveCorp

Diller didn't get where he is by being sweet, and neither did InterActiveCorp, the New York Web giant built in the image of its pug-nosed 61-year-old CEO.

The former Hollywood mogul traded his media and entertainment empire and has bought up some of the most successful businesses in the e-commerce world, including Expedia, eBags.com, Ticketmaster, and mortgage site LendingTree. More than anyone else, he has figured out that power flows to Internet middlemen in markets that don't have entrenched leaders. His targets: travel, real estate, and local entertainment. If his company keeps growing at its current pace, it will hit \$6.2 billion in revenues this year, bigger than Amazon.com and eBay.

Diller believes that if you harness the Web to round up boatloads of customers, you can get a better deal for consumers and take a fat slice for yourself. Diller's strategy puts a lot of focus not just on other middlemen but also on IAC's own suppliers—the airlines and hotel chains. The Internet “pulls [power] from suppliers and puts it in the hands of consumers,” Diller says. “If you direct that demand, it gives you natural leverage.” And leverage is something Barry Diller knows how to



Eric Schmidt Google



When Eric E. Schmidt, the 48-year-old veteran of Sun Microsystems and Novell, took over at Google Inc. two years ago, it was trial by fire. One of the first orders of business was joining his new 20-something colleagues at Burning Man, a free-form festival of artistic self-expression held in a Nevada desert lake bed. Sitting in his office shortly af-

ter his return, tanned and slightly weary, Schmidt couldn't have been happier. “They're keeping me young,” he declared. Google is proving the Net is still young, too. The free-wheeling company has almost singlehandedly recharged Web surfing, a business that pioneers such as Yahoo! Inc. forgot. Google is the most-used conduit between Net users and the information, responsible for answering roughly three-quarters of all searches. Indeed, it took an upstart Google to help show the Net's leaders how to make money by linking ads to search results. Now, paid search is one of the Net's most profitable enterprises, especially for Google, which is expected to be in the black on revenues of \$700 million this year. Its initial public offering, likely next year, could open the IPO gates for tech companies.

Schmidt's challenge: keeping Google focused even while beating back a growing pack of rivals, such as Yahoo! and Microsoft Corp.'s MSN. If Schmidt pulls this right, it will be the competition that has been burned.

BusinessWeek online

Q&As with Jeff Bezos and others in the e.biz 25 can be found at www.businessweek.com/magazine/extra.htm

Architects

Sean Maloney Intel

Sean M. Maloney loves a dare. The 47-year-old Intel Corp. executive vice-president has swum across the Thames and cracked ribs racing down perilous ski slopes. In January, 2001, he accepted a new challenge.

The head of the chipmaker's communications group set about helping to establish a global standard for wirelessly tapping the Net. The appeal is obvious: With one worldwide technology, you could travel from New York to New Delhi and use the same gear to cruise the Web. The goal had confounded the telecom industry for decades as rival companies rolled out a mishmash of competing technologies.

Maloney ultimately settled on an overlooked solution: Wi-Fi. The technology, which uses unlicensed spectrum to connect devices wirelessly, rapidly gained appeal among techies. But by combining Wi-Fi with a new low-power mobile processor, Maloney is bringing Wi-Fi to the masses. “The first wave of e-biz productivity was driven by the Web,” he says. “The second is going to be driven by mobility and broadband.”

Six months after unveiling its Centrino Wi-Fi chip and processor package with a \$300 million marketing blitz, Intel has sparked renewed innovation and excitement in the computer and wireless industries. Not bad for a quest that at first seemed Quixotic.

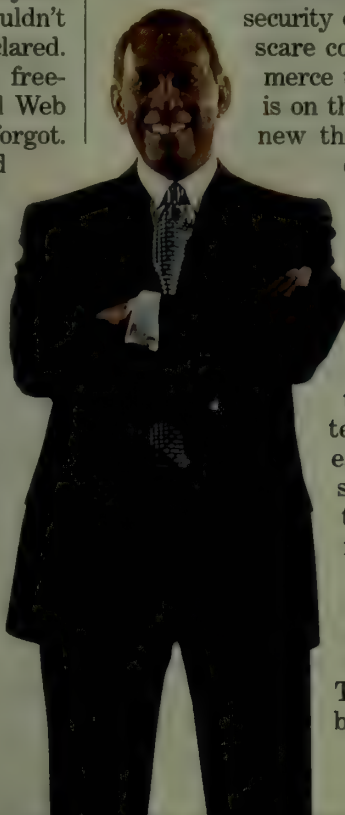


John Thompson Symantec

John W. Thompson, CEO of No. 1 antivirus software company Symantec Corp., carries a heavy burden. Powerful new viruses and wily hackers are a growing danger to the security of the Internet these days, threatening to scare consumers away and slow electronic commerce to a crawl. More than anyone, Thompson is on the spot to come up with a parry for each new thrust. His answer: Give consumers and

corporations a whole array of defenses in one integrated package. Since Thompson left behind a 25-year career at IBM and moved into the corner office of the Cupertino (Calif.) company three years ago, Symantec has spent more than \$1.4 billion acquiring 12 companies that do things like intrusion detection, personal firewalls, and spam filters. Packaged together, the features are easier for people to use. “We're trying to stay one step ahead of the bad guys and two steps ahead of our customers' needs,” says Thompson, 54.

There's plenty of demand for his wares. While sales of nearly every other type of software shrank last year, antivirus sales grew 31%, to \$2.19 billion. That helped Symantec boost its revenues by 24%, to \$391.1 million, in its most re-



cent quarter, while profits jumped 19.3%, to \$68 million. With new bugs popping up every day, the demand for Thompson's products will spread like a virus.

SAM PALMISANO IBM



Samuel J. Palmisano has spent every single day of his 30-year career working at IBM, so you might think he's a defender of the status quo. No way. He's shaking up Big Blue, pushing the development of the Windows alternative Linux operating system, and remaking the company around a new technology vision called e-business on demand.

This year, IBM is spending one-third of its \$5 billion research budget on the e-biz initiative, plus \$800 million marketing it. All of IBM's product groups—services, software, hardware—are developing capabilities that will help fulfill the vision. And the rest of the industry is following his lead.

The idea behind this initiative is to provide corporate customers with computing power as simply and reliably as an electric utility. The technology will be delivered over the Internet, and customers will only pay for what they use. Palmisano says the shift will drive the next round of productivity gains by making it easier and cheaper for companies to get a bang out of technology.

MICHAEL MORITZ Sequoia Capital

Michael J. Moritz has a habit of backing winners that others thought might be losers. The 49-year-old venture capitalist at Sequoia Capital funded upstart Google Inc. in 1999 when most pundits thought the search-engine winners already had been picked. But Moritz believed in Google's technology. "It's all too easy to identify the things that might go wrong with an investment," explains Moritz. "It's far more difficult to identify what might be possible." In spite of his high-risk approach, Moritz has maintained one of the best performing records in venture capital, even during the downturn.

Now he's gambling on Plaxo Inc. because he sees big potential in the startup's little idea of keeping electronic address books automatically up-to-date. Moritz is a reminder to the rest of the venture industry: safer isn't better. That's good news for tech's next generation of innovators.



IVAN SEIDENBERG Verizon



When it comes to e-business, most telecom companies are more talk than action. Not Verizon Communications Inc. and its CEO, Ivan G. Seidenberg. He's making the investments now to turn the promise of ubiquitous broadband connections into a reality.

Over the next 10 to 15 years, he expects Verizon to spend \$20 billion to \$40 billion to provide superfast Net

connections to every home and business in its 29-state territory. At least 10 times faster than today's broadband services, they will be able to carry everything from phone calls to high-definition television. That will support a new generation of digital interactivity. Imagine a world in which customer service and sales are once again conducted eye-to-eye, but over the Web. "Broadband is the digital economy," Seidenberg says. And he aims to be its master builder.

Innovators

SANJAY SARMA MIT's AutoID Center

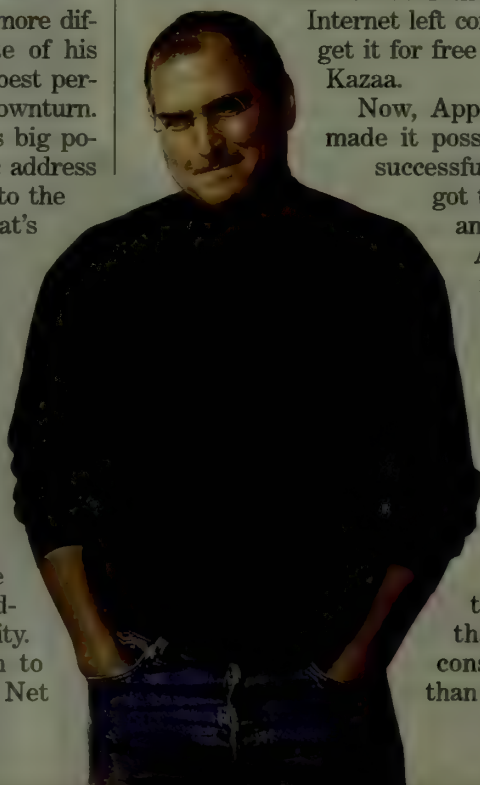
Normally, when somebody says robots, you think R2-D2. But Sanjay Sarma, a robotics expert and professor of engineering at MIT, has taken the science of sensors down to the micro level. As a result, he's accelerating the pace of e-commerce. Sarma, 35, has helped create a new technology to track razor blades, shampoo bottles, and more from the factory to the warehouse to the supermarket shelf. The tech, called RFID, is based on chips that can be read remotely via wireless Internet connections. It's designed to help shelves full as well as reduce loss, theft, and inventory costs for retailers and their suppliers. It is becoming the technology standard for the entire retail industry. Sarma believes someday "anything you have to touch and count will have RFID tags." Maybe then you won't lose your cell phone.



STEVE JOBS Apple

Count on Apple Computer Inc. Chief Executive Steve Jobs to "think different," as his well-known advertising campaign admonishes. Until Apple unveiled its iTunes Music Store in April, bickering between record companies and online retailers over the best way to sell music on the Internet left consumers with little option but to get it for free via file-sharing services such as Kazaa.

Now, Apple has broken the logjam and made it possible for the music industry to successfully sell tunes on the Web. Jobs got the five major labels to agree to an appealing, simple set of terms. All songs would go for 99¢, with no frustrating restrictions limiting fans' right to burn them to CDs, load them in a portable player, or share them with a few friends. Four months later, Apple has sold more than 10 million songs, and rivaling Amazon.com and Microsoft Corp. in planning copycat services. Says Jobs: "We've shown there's a way out of this mess: that there's a legal alternative consumers can use that's better than stealing online."





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Now, Jobs is looking to go further. By yearend, Apple expects to extend the iTunes Music Store to work with PCs that run Microsoft's Windows operating systems, which represent more than 95% of the market. The trick for Jobs is to avoid leaving Apple where it often ends up—doing much of the innovation and getting a small cut of the sales.

MARK BENIOFF Salesforce.com



Wags in the technology industry used to poke fun at Marc Benioff and his pint-sized startup, Salesforce.com Inc. No more. Benioff, 38, hasn't changed his shtick. He's the same in-your-face marketing whiz who grabbed attention by setting up pickets bearing "End of Software" signs outside events sponsored by rival software giant Siebel Systems Inc. But he and

his four-year-old company can no longer be dismissed by Siebel. That's because Benioff, more than anyone else, is demonstrating to corporations that buying software delivered as a service over the Web is a viable alternative to software packages that can cost hundreds of thousands of dollars and take months or years to install. For other software companies, he shows that they can make money selling software as a service.

The proof is in his company's results. Salesforce.com, a San Francisco-based seller of services for managing sales forces and a company's customer service, posted revenues of \$21.6 million in the second quarter, double those of a year earlier, and logged its second sequential quarterly profit. It is the first corporate software-as-a-service outfit to make a profit. "This is a new way of selling software. We have a huge obligation to prove that the model works," says Benioff.

Software giants are being forced to respond—including Siebel. Analysts say the company is working on its own software-as-a-service offering to counter Benioff's, though Siebel won't comment. You know what they say about imitation and flattery....

JORMA OLLILA Nokia



When the telecom industry crashed three years ago, Nokia Corp. Chairman Jorma Ollila and his wife were refurbishing a 200-year-old manor house north of Helsinki. The easy path for Ollila would have been to focus Nokia on its strength in mobile handsets—and to back away from tackling the much derided wireless Web.

The pay-off: fewer headaches, more time in his new sauna.

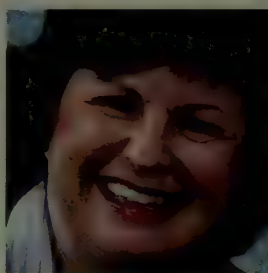
But Ollila veered the other way. He doubled down his bid to turn Nokia into a software powerhouse, investing in everything from billing to messaging systems. He upped the ante against rival Microsoft Corp. by licensing Nokia's interface software to cell-phone competitors. He's become a leading force in building the mobile Internet.

And his efforts are paying off. Around the world, tens of millions of mobile customers using software from Nokia and others now click their handsets to get e-mail, swap photos, and download games—just like on PCs. All told, researcher

IDC figures the global mobile-data business will surge 47% this year, to \$29.5 billion. "We've made enormous progress," says the 53-year-old Ollila. Indeed, the mobile now has a distinctly Finnish flavor.

WebSmart

LINDA DILLMAN Wal-Mart Stores



Linda Dillman wasn't angling for one of the highest-profile tech jobs in the world. Honest. Dillman turned down a job with Wal-Mart Stores Inc. in 1991 when it boomed as an employer of hers. Only after a new employer was sold to a private buyer did she join the rapidly growing retailer. "I was tired of being overlooked," she says. Last year, she

climbing through the ranks of the tech department, Dillman, 47, landed the powerful post of chief information officer.

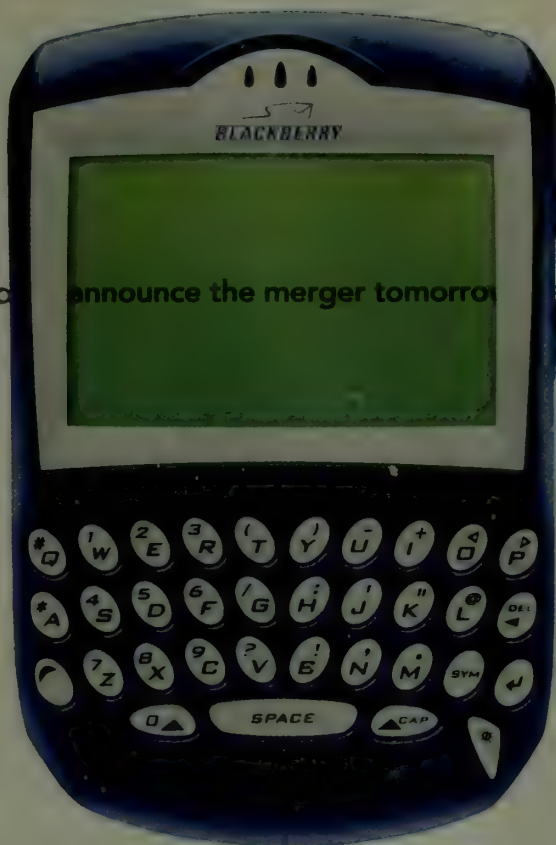
Now, she's setting the technology agenda not just for Wal-Mart but for the whole \$2.7 trillion U.S. retail industry. A top priority is to spread radio-frequency identification tags, RFID, throughout Wal-Mart's vast supply chain. This will allow the company to use the Web to track inventory from factories in China to store shelves everywhere. She has ordered the company's top 100 suppliers to start putting the tags on each case of goods by 2005. The rest of the industry is sure to follow. Dillman also is pushing an industrywide initiative to have suppliers create a single, centralized database of products on the Net. The goal: fewer errors in restocking products and faster introductions of new items. She's on her way to turning the entire retailing industry into an e-business.

MICHAEL DELL Dell

At age 38, Michael S. Dell is the master of electronic business. From his headquarters in Round Rock, Tex., he runs a \$500-million-a-day online distribution channel—equivalent to five Amazon.coms. More than anyone, Dell has shown how to use the Web, intelligently used, drives efficiency.

Now he's carrying his network magic to the next level. At a time when many tech companies are paring costs, Dell is pushing on new technology. He's tagging parts with radio-powered ID chips. At plants from China to Texas, online orders are transformed quickly into radio signals. These instructions tell Dell's automatic parts-picking machines to round up the components for each PC. They also transmit assembly blueprints to workers, and track the shipping of the finished product. Dell's managers can monitor the entire process in real time. Dell also is using his e-commerce machine to sell a vast range of new offerings, from PCs and printers to plasma





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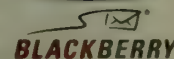
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 **BLACKBERRY**

screen TVs. It's working as he planned, with sales soaring 16% in the most recent quarter. Says the CEO: "There's lots of ways for Dell to grow."

DAVID NEELEMAN JetBlue



When 44-year-old David G. Neeleman set out three years ago to build his startup airline, JetBlue Airways Corp., he bet big on the Net and took chances on things nobody had tried before. Look no further than JetBlue's 700-person reservation center in Salt Lake City. You don't see it? That's because its sales agents all work from their

homes. They're linked by an Internet telephone system in which e-mail, chat, Web searches, and phone calls all pour through the same pipes. JetBlue's 600 pilots use laptops to replace cumbersome paper flight manuals. And Neeleman appeals to travelers with electronic tickets and in-cabin satellite TV. "As long as we can delight our customers, there's plenty of business for us," he says. If traditional airlines don't follow JetBlue's lead, there may not be much room for them in the super-efficient airline industry of the future.

Visionaries

HOWARD RHEINGOLD Author of *Smart Mobs*

It's no surprise that someone who prowls the "territory where minds meet technology" runs across some potent techno-trends, from personal computers to virtual reality. People who read Howard Rheingold's book *The Virtual Community* in 1993 understood the Internet would grow into something



big. That's why they had best pay attention to his current obsession: a phenomenon he has named "smart mobs."

In his latest book of the same name, the 56-year-old Marin County (Calif.) author and builder of pioneering online communities such as Electric Minds argues that ubiquitous mobile Internet communications are spurring a new social revolution. The early signs include urban hipsters using the Web to arrange ad-hoc "swarms" of people for fun and political action, as well as Filipino protesters mounting rallies via cell-phone text messages.

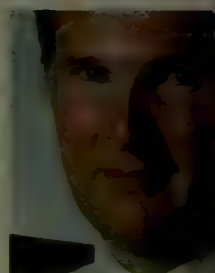
True to form, Rheingold ends up with a provocative ques-

tion: "What can you do when you have a billion people hanging around with computing devices connected at high speed? He's not sure exactly what tangible business application might result. But it's a good bet he's onto something once again.

JOHN ARQUILLA U.S. Navy

During the Iraq War, the military's sensors, weapons, communications, soldiers, and commanders were all linked to a giant computing grid that gave U.S. troops the clearest picture of the battlefield they've ever known. No one person is more responsible for pushing this idea of network-centric war than John Arquilla, a RAND Corp. analyst and professor at the Naval Postgraduate School. Arquilla's influence through his writing, teaching, and consultation with military officials. And his ideas are changing the face of the defense industry.

To the soft-spoken, 49-year-old Arquilla, the first Gulf War was a revelation. During it, he advised the U.S. military's Central Command. "I came back from that experience with a strong sense that this information advantage was the difference that made the difference," he says. In war, as in business, it appears the future belongs to the nimble and the networked.



ERIK BRYNJOLFSSON MIT Economist



If e-business had an oracle, Erik Brynjolfsson would be the one to consult. Companies from Dell Computer to General Motors look to the economist and his team of researchers at the Massachusetts Institute of Technology for answers on how to reap productivity payoffs by combining e-business technology with organizational changes. In 1998, he even

opened his own research outpost, the MIT Center for eBusiness, which is backed by 19 companies.

Brynjolfsson, 41, earned his reputation as an expert on tech's productivity boost by sifting through data from hundreds of companies. In the past 10 years, he has published groundbreaking research, often working closely with Wharton School economist Lorin Hitt. A key finding: Corporations can log productivity gains of 30% or more in a single year through smart use of technology. Who says economics is a dismal science?

KEN KUTARAGI Sony

Ken Kutaragi, the whiz behind Sony's PlayStation, has always been something of a seer. In the early 1980s he developed a forerunner to the digital camera. By the early '90s, he convinced Sony's senior executives to bet big on the first CD-based game console with decent sound and 3-D graphics. That morphed into the PlayStation franchise.

Now, the 53-year-old Kutaragi, executive deputy president of Sony, is creating a vision of the e-home that could



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shape both the PC and consumer electronics industries. At its center is a superfast microprocessor, dubbed the Cell, that will go into a wide variety of Sony products, including PCs, PDAs, and the PlayStation update, PS3, which will be a home entertainment hub for downloading and storing movies, games, music, and data. The chip will enable zippy networking and interactive games with graphics as stunning as those in the movie *The Matrix*, says Kutaragi. If Kutaragi places Sony in the center of the e-home, there's a good chance he'll end up running the entire company.

Up-and-Comers

MARK GOLDSTON United Online



Normally, two wrongs don't make a right. But they do for Mark R. Goldston. In 2001, the 48-year-old eternal optimist merged NetZero and Juno—two providers of free Internet service that never earned a penny between them—and promised a skeptical Wall Street he'd make the marriage profitable. Well, he has done just that. In the fiscal

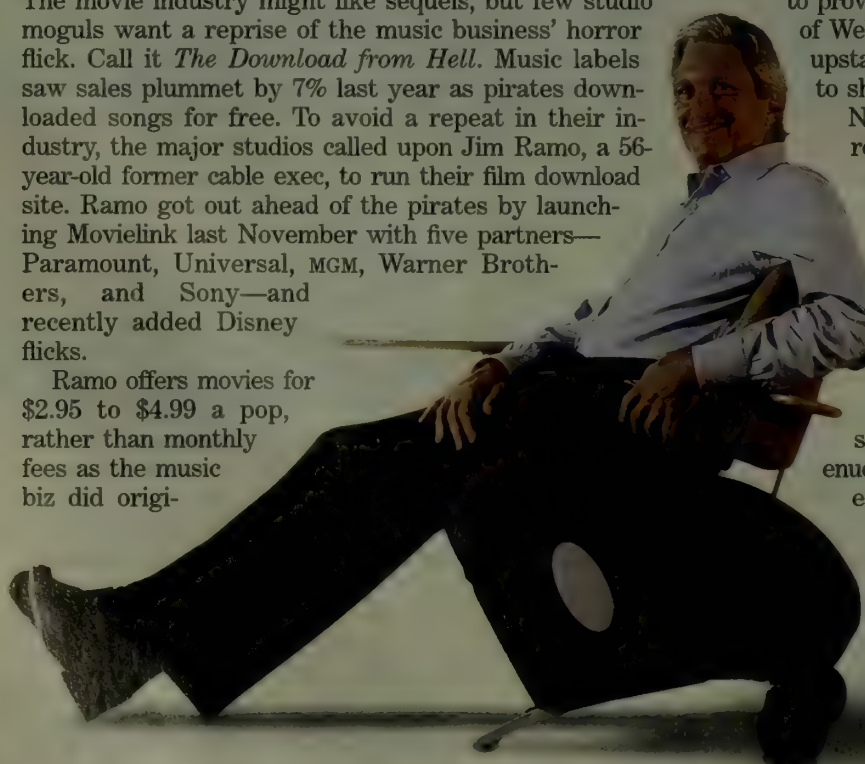
year ended June, 2003, United Online racked up a \$27.8 million profit as sales jumped 66%, to \$277.3 million.

Goldston has proved that it's possible to create a successful Net service for the masses that's both dependable and supercheap. United's \$9.95 monthly charge, less than half America Online's rate, not only is drawing customers away from the big brands but it's also attracting first-time Net surfers who couldn't afford a premium price. Goldston is well on his way to creating the Southwest Airlines of the World Wide Web.

JIM RAMO Movielink

The movie industry might like sequels, but few studio moguls want a reprise of the music business' horror flick. Call it *The Download from Hell*. Music labels saw sales plummet by 7% last year as pirates downloaded songs for free. To avoid a repeat in their industry, the major studios called upon Jim Ramo, a 56-year-old former cable exec, to run their film download site. Ramo got out ahead of the pirates by launching Movielink last November with five partners—Paramount, Universal, MGM, Warner Brothers, and Sony—and recently added Disney flicks.

Ramo offers movies for \$2.95 to \$4.99 a pop, rather than monthly fees as the music biz did origi-



nally. He hopes to beat the ripoffs with discounts to college and new technology that speeds downloads. "We're offering tiled water in a world where water comes from the tap," says. Keep adding hit films to the roster, and it could be known as *The Web Site That Saved Hollywood*.

CHARLES ZHANG Sohu.com



Lots of CEOs say they'll go the mile for their company. Few more literally than Charles Zhang, founder and chief executive of Chinese portal Sohu.com. This spry Zhang, 38, tagged along part of the way when a Sohu-sponsored team climbed Mt. Everest and sent pictures back to the Sohu Web site.

"We achieved something that no man beings never did," he says.

For Zhang, the Everest stunt was just the latest effort to popularize the Internet in China, where only about 15% of the urban population has Net access. He's an inspiration for site operators across the developing world who face hurdles to win over the masses. "People perceived the Internet as something too technical," says Zhang. Thanks to high-profile exploits, he says, "people who know nothing about computers now realize they can make life so interesting." Zhang attracts 20 million users a day, a big chunk of China's 68 million-person Net community, and it's profitability is helping to send the stock soaring in the past year.

Now, Zhang is putting his hiking boots back on for another Sohu promotion, a trek up a Tibetan holy mountain. Whatever it takes to glamorize the Net, he's ready to do it.

JOE FEDELE FreshDirect

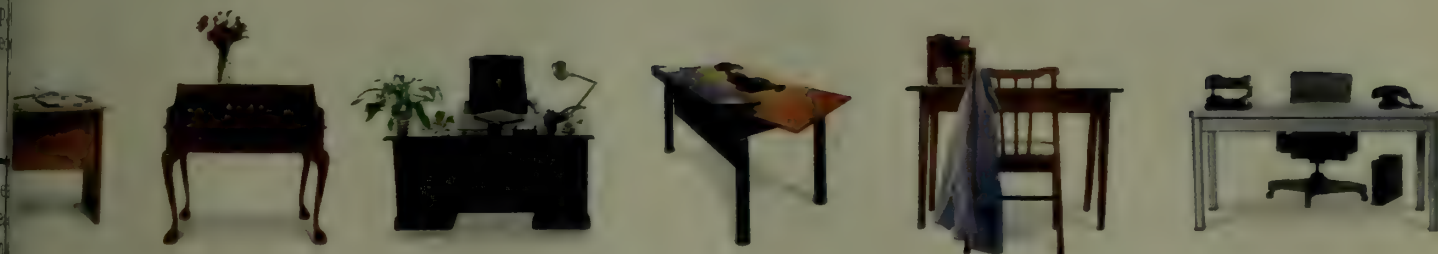
Grocery shopping over the Net looked like an idea that got buried in the dot-com rubble. Nothing seemed to prove that more than the collapse of Webvan, the Foster City (Calif.) upstart that raised \$1 billion only to shut down in July, 2001.

Now, however, Joe Fedele is rekindling hopes that people across the country will be

able to stock their refrigerators without darkening grocery's doors. Armed with \$100 million, Fedele, launched FreshDirect in Manhattan last September. Next up is expanding into the outer boroughs and within three to five years, opening operations in Atlanta, Boston, and Chicago.

He says business is booming. While the private company's finances aren't publicly available, Fedele says FreshDirect is on track to take in \$90 million in revenues this year and post a profit in four to five months. Its early success is due partly to Fedele's expertise as a former co-owner of Fairway Uptown, a low-cost, high-end grocery. FreshDirect also deals directly with producers and makes much of its food to order, allowing it to undercut rivals by up to 25%. "We took the Internet model and brought it to the grocery business," Fedele says. Nothing like learning from the success—and mistakes—of others.





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Thin Frame	Yes	Yes	Yes	Yes	Yes	Yes	Yes
NaViSet (DDC/CI)	Yes	Yes	Yes	Yes	Yes	Yes	Yes
No Touch Auto Adjust	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Integration Capable	Yes	Yes	No	Yes	Yes	No	Yes
LiquidView™ Software	No	No	No	Yes	Yes	Yes	No
Multimedia	No	No	Yes	No	No	Yes	No
Vacation Switch	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Cable Management	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Input Interface Connectors	VGA	DVI-D & VGA	DVI-D & VGA	VGA	DVI-D & VGA	DVI-D & VGA	DVI-D & VGA

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Derrick Warren, IBM variable cost guru, retail industry

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MAKING LIFE RICHER

Active or Passive

The Debate Over
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Heats Up
Page 134

FUNDS 138

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Conundrum

FOOD 140

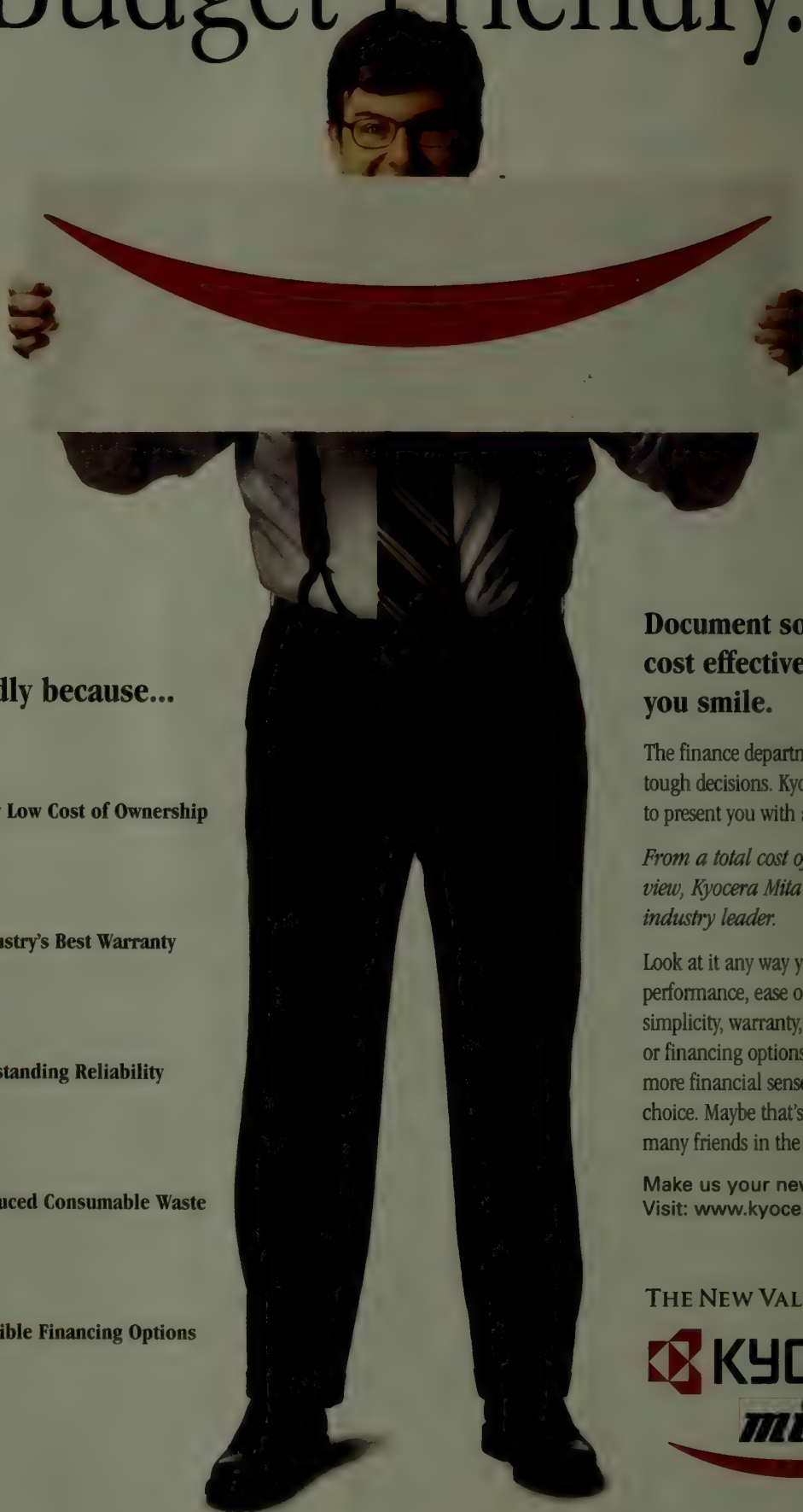
New Tastes
in Cheese

MARKER 144

Screening for
Dividends



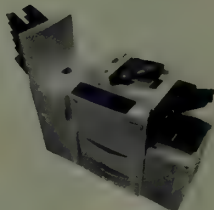
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0	0.5x	1x	2x	2.5x	3x
% OF YOUR ANNUAL SALARY YOU SHOULD BE SAVING					
11%	8%	5%	0%	0%	0%
14	11	8	3	0	0
19	15	12	6	3	0
26	22	19	12	8	5
38	34	30	21	17	13
64	58	52	40	34	28

Assumes 3% inflation rate, 7% rate of return, retirement age of 65, and 70% of pre-retirement income
needed. Portfolio consists of 60% stocks, 30% bonds, and 10% cash.

Data: T. Rowe Price



CURRENCIES

China Play

MANY FOREIGN-EXCHANGE experts are betting
that China will buckle under U.S. pressure and al-
low its currency to rise against the dollar by 3% to
10%. Here's a way to cash in: Open an FDIC-insured
money market account that reflects the value of
the **Chinese renminbi (also called yuan)** at online bank Everbank
(everbank.com). If you invest the minimum \$10,000 and the
currency appreciates by 10%, for example, you'll earn \$1,000.
Of course, if China devalues, you'll lose money.

This is no ordinary account. Because China imposes strict
controls on trading in renminbi, an official at China's State Ad-
ministration of Foreign Exchange says it needs more infor-
mation before it can assess the accounts' legality. Everbank
president Frank Trotter says that's not a concern. Everbank,
he says, operates under U.S. law. Moreover, **it never actually
purchases renminbi**. Instead, it buys forward contracts from
other U.S. banks that are denominated in dollars but tied to
the renminbi. As a result, when you cash out, you'll receive dol-
lars—not renminbi. You'll also get interest, albeit not much: To-
day's rate is 0.5%.

Anne Tergesen

Should You Time The Market?

It all depends on how you think the market works. But it's easy to get your timing wrong, so don't stray far from your target mix. **BY PETER COY**

THE BEAR market turned buy-and-hold investors into hem-and-haw investors. People who bailed out are agonizing over whether the time is right to jump back in. In other words, they're trying to time the market—just what they used to vow they would never do.

Does it make sense to time the market, or are you better off adhering to your target mix of assets—say, 60% stocks, 30% bonds, and 10% cash? New research has brought fresh economic insight to the issue. The bottom line: Ordinary investors probably can come out a little bit ahead by timing the market. But it's easy to get your timing wrong, so don't stray far from your target.

One of the most respected academic proponents of cautious market timing is John Y. Campbell, an economist at Harvard University and a managing partner of Arrowstreet Capital LP in Cambridge, Mass., which manages \$4 billion of international stocks for pension funds and endowments.

To make his case for market timing, Campbell divides people into two camps: those who believe that stock prices move in a random walk, and those who believe that they revert to the mean. If the random walkers are right, then

stocks aren't a safe long-term investment, because the range of possible outcomes comes rapidly widens over time. To say that, in any given year, stock prices go up or down randomly by as much as 25%. After one year, your \$100 could turn into a maximum of \$125 or a minimum of \$75. But if you left the money for 20 years, it could grow to as much as \$8,670 or shrink to as little as \$3.

That's why most people who allocate stocks as a long-term investment

YES Stock prices fluctuate but tend to revert to their long-term growth trend. So it makes sense to cut back when they seem overpriced and buy extra when they seem underpriced

JOHN Y. CAMPBELL

reject the random walk. Instead, they believe in mean reversion, where the range of likely outcomes comes widens much more slowly. Mean reversion says that if price-earnings ratios have gotten way above average in the 1990s, their return

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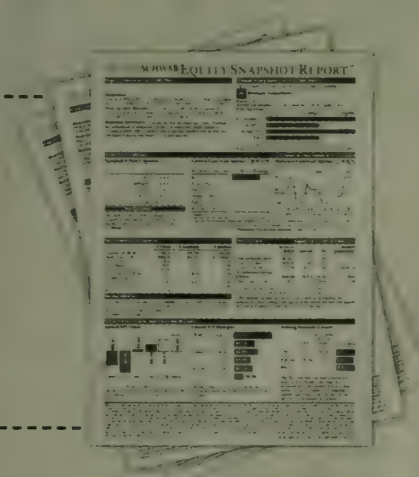
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charles **SCHWAB**

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move is likely to be down (as in the 2000s). Think of it this way: An imaginary mean-reverting coin that came up tails nine times in a row would probably come up heads on the 10th throw, whereas an ordinary, random-walk coin has a 50% chance of coming up tails yet again.

MIND-BOGGLING

Assuming that mean reversion holds, you should be able to profit by buying when stocks are low and selling when they're high. Yet pure buy-and-holders don't do that. Campbell argues that their disbelief in the potential for market timing is "logically inconsistent" with their belief that mean reversion makes stocks safe for the long run.

The theoretical potential of market timing is mind-boggling. Economist Andrew W. Lo of Massachusetts Institute of Technology calculates that someone who invested all his money in either the Standard & Poor's 500-stock index or Treasury bills, somehow correctly picking each month the one that would go up the most, would have turned \$1,000 in 1926 into \$14 trillion in 2002.

That, of course, would have required faultless foresight. Campbell advocates something more modest: "aggressive re-balancing." For instance, if your target is 60% stocks and a bull market raises stocks' share to 80%, consider selling stocks to bring the allocation down to, say, 50%. Just don't overdo it. "Strategic market timing should be done cautiously," says Campbell, "because people are likely to mess it up."

Campbell may seem diffident, but he's a bull on market timing compared with Wharton School economist Jeremy J. Siegel, author of *Stocks for the Long Run*. True, Siegel wrote a prescient op-ed piece, "Big-Cap Tech Stocks Are a Sucker Bet" that ran in *The Wall Street Journal* on Mar. 14, 2000, virtually the bull market's peak. Even though he nailed that one, Siegel says, "once you open the door to market timing, unless you're extraordinarily disciplined, you

Memo to investors who bailed out of stocks: Get back in—not because the time is ideal, but because you're probably below your target allocation on equities

often get it exactly wrong." Burton G. Malkiel, author of *A Random Walk Down Wall Street*, points out that mutual funds tend to sit on the largest amount of cash when stock markets are at their bottoms and the least when they're at their tops—the opposite of what they should do.

People who do believe in active management have long regarded market timing as a better choice than stock-picking. That goes back to a 1986 paper

by a group led by Gary P. Brinson of Chicago's GP Brinson Invest. Remember that market timing—another name for asset-allocation—because the way you time market periodically changing your mix sets between stocks, bonds, and The Brinson team famously concluded that the balance of asset classes—rather than the choice of stocks—accounted for 94% of the variation in mutual fund returns over time.

A new study shows that the value of asset allocation—i.e., market timing—isn't as potent as the Brinson paper implied. Stock-picking is a more powerful method of active management, says research by Mark Kritzman, managing partner of Windham Capital Management Boston LLC, and Sebastien F. Page, senior associate at State Street Advisors. But Kritzman and Page don't advise investors to ditch their index funds and instead pick stocks. While stock-picking can produce higher highs than asset allocation, it can also produce lower lows. So if you aren't highly skilled, Kritzman says, you'll probably do more harm by toying with stock selection than you would by tinkering with asset allocation.

The upshot: Active investing through cautious re-allocation of assets might add juice to your returns, but it's no substitute for the basics, like setting a sensible target asset allocation and keeping investment costs low. Both Kritzman and Campbell put a lot of their own money in plain-vanilla funds.

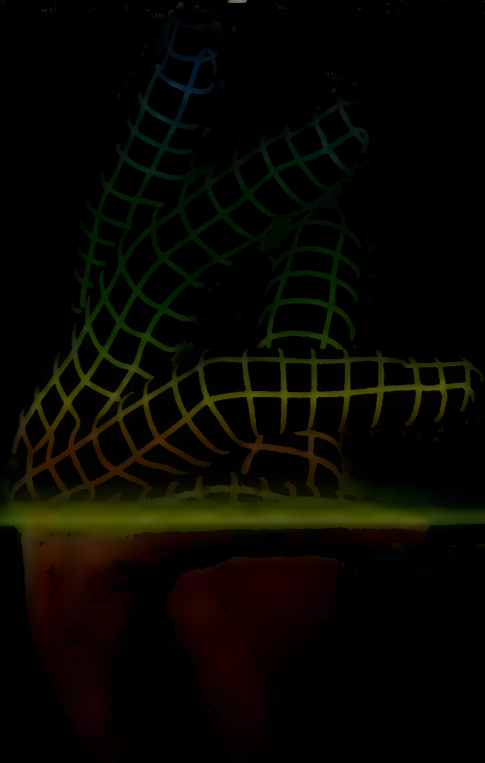
Memo to investors who bailed out of stocks: Get back in. Not because this is an ideal time to invest—who can be sure of that?—but because you're probably under your target allocation on stocks. And for most of us, sticking to the plan is the biggest factor in investing success.

NO Smart investors can get better results by picking stocks than by timing the market. Others would be better off sitting tight

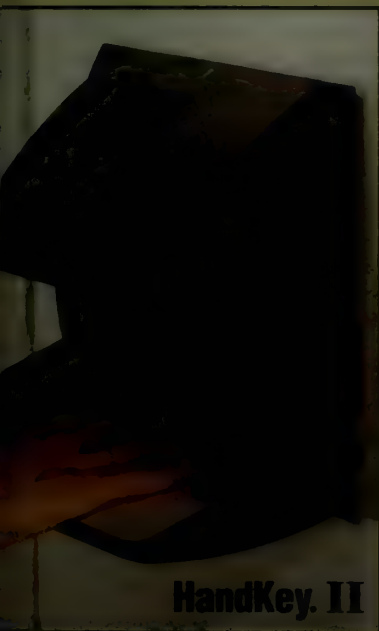
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Closed-Ends: The Window Is Closing

Their heavy reliance on bonds makes them risky when rates are rising. **BY IAN KATZ**

YOU COULD call it the year of the closed-end fund. In 2003 so far, 33 new funds have raised \$20.6 billion in initial public offerings, topping a previous record of \$18.5 billion for all of 1993. Rights offerings, which allow current holders of a fund to buy new, often discounted shares, are being issued at their fastest pace in at least five years.

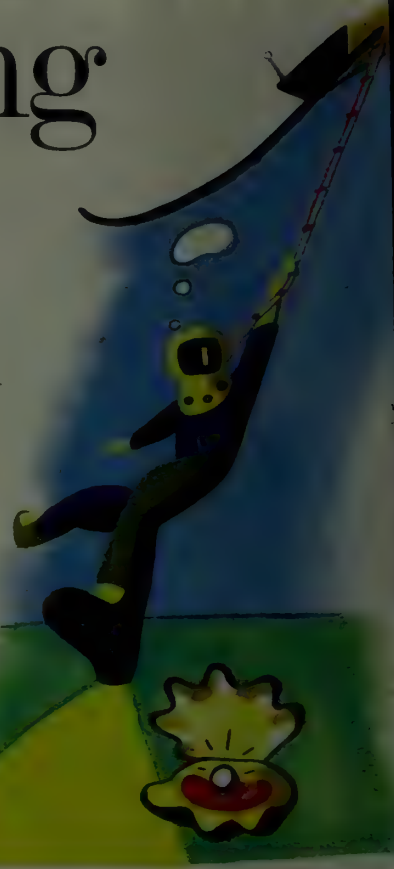
The funds have been attractive to investors craving higher yields, and indeed, the average return of the 570 closed-end funds now trading is up 5.1% this year. Unlike mutual funds, which make new shares available when investors want to buy and redeem when they sell, closed-end funds issue a fixed number of shares that trade on a stock exchange. Depending on demand, closed-end funds trade at a price higher or lower than their net asset value (NAV), the value of the securities owned by the fund. But if you're just now thinking of buying a closed-end fund, this may be

a case of the party ending before the final guests arrive.

The reason: Most of the funds, including nearly all the recent issues, are leveraged funds holding bonds, which perform best when interest rates are falling or flat. As rates creep up, bond prices drop, punishing the funds' NAVs.

The leveraged funds, which borrow money at low, short-term rates and invest it at higher, long-term rates, can offer yields reaching 10%. The problem is that rising rates might prompt funds to reduce leverage by selling assets, which could cut the dividends.

Some fear is already setting in. Muni funds, which account for about half of all closed-end funds, have fallen 6.4% since mid-June and are up just 3% for the year. "People who buy leveraged bond funds could lose a third of their money in the next five years," warns Thomas Herzfeld, whose Miami firm specializes in closed-end funds. Also avoid funds trading at large premiums over their NAVs, such as DNP Select Income, which invests in public utility stocks and debt (table).



Closed-End Funds: Picks and Pans

WORTH A LOOK...

FUND/SYMBOL	PRICE	CURRENT YIELD
MBIA Capital/Claymore Managed Duration MZF Insured, high-quality bond fund managed by savvy Claymore Securities	\$15.00	NA
Federated Premier Intermediate Muni. Income FPT The key word is intermediate. Less risky than long-term bonds	13.76	5.7%
Preferred Income Opportunity PFO Flaherty & Crumrine shines among preferred-stock fund managers	12.44	7.0

...BEST TO AVOID

DNP Select Income DNP A leveraged fund trading at a pricey 41% premium to net asset value	10.56	7.4%
Gabelli Utility Trust GUT Trading at premium of 28%. Dividend could be ripe for trimming	8.16	8.8
Putnam High-Yield Municipal PYM Underperforming in a peer group of gainers	6.85	6.7

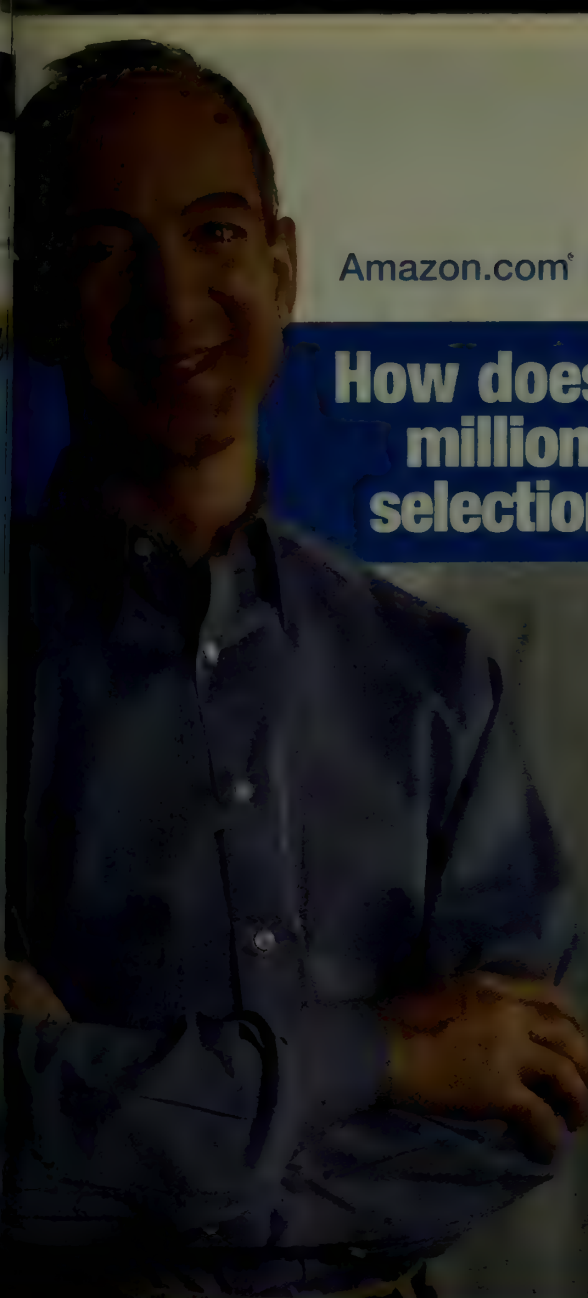
NA = Not available

Data: Lipper Inc.; Thomson Financial

O.K., never mind buying—is it to sell? Maybe. First, says Don Sidy, a senior research analyst at Lipper, check how exposed the fund and entire portfolio are to rising rates. You want to know the average maturity of the bonds in the fund and, if applicable, the amount of leverage it has. A leverage-to-asset ratio of more than 1.5 should raise a red flag. You can check that out from the fund—or from a dedicated site, closedendfunds.com. The longer the maturities, and the greater the leverage, the greater the risk as rates rise. "If you can't stand swells and down of 10%, you shouldn't be in the leveraged closed-end pool," says E. J. Chovia Securities analyst Mariana F.

It's important to examine the makeup of the fund's borrowings. Amy Hawley, director of closed-end-fund research at Raymond James & Associates, likes funds that have locked in their borrowing costs at low rates, making them less vulnerable if rates head upward. Look for funds with cash cushions; they will be less likely to cut dividends.

The high yields offered by leveraged closed-end bond funds are tempting. As interest rates climb, you might be better off sitting on the sidelines.



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The Power to Know.



New Ways to Say Cheese

You'll find a growing selection of the handmade kind at green markets, on the Net, and even at the local grocer. **BY JANE BLACK**

Twice a month at New York's Artisanal Cheese Center, two dozen food fanciers pack a gleaming classroom for Cheese & Wine 101. In front of each student are four wine glasses and an immense plate of aromatic cheeses, including perhaps a Hoja Santa, a spicy Texas goat cheese laced with coriander, or a nutty Comté from the Jura Mountains in Switzerland.

Students come to get an overview of cheese types, textures, and flavors and to learn to match cheeses with the wines that best suit them. They've come to the right guy: Their teacher, Max McCalman, maître fromager at New York's celebrated restaurant Picholine and dean of curriculum at the center, is on a self-proclaimed mission to get cheese "the respect it deserves."

Perfect timing. After years of stomaching processed yellow substitutes for real cheese, Americans can find a huge selection of domestic and imported handmade kinds at farmers' markets, on the Internet, and even at their local grocers. The Artisanal Cheese Center, which opened in May on West 37th Street and 10th Avenue, has a Web site, artisanalcheese.com, that sells more than 100 cheeses, perfectly ripened in one of five high-tech caves. They range from \$8 a pound to \$32 a pound.

Americans' newfound interest in cheese stems in part from a growing desire for fresh, natural, locally grown foods, a cause long championed by Alice Waters of Chez Panisse in Berkeley, Calif. and other respected chefs.

The trend has helped dozens of small U.S. dairies, which have discovered that \$150 worth of milk can bring in \$800 to \$1,000 when sold as cheese. "Cheese is appealing because it's

handcrafted and, like wine, unique to the farm it came from," says Sue Conley, founder of the Cowgirl Creamery in Point Reyes, Calif. Conley turns out 3,000 pounds of the stuff each week, including fresh cottage cheese for \$7.25 a pound and St. Pat, a mellow, buttery cheese wrapped in nettle leaves, for \$17.50 a pound. Conley sells to consumers and restaurants via cowgirlcreamery.com and in her new store, Artisan Cheese, in San Francisco.

With so many new cheeses available, how do you know where to begin? Aficionados divide cheeses into goat, sheep, or cow, depending on the milk used. Within each group are various kinds of rinds, including natural rinds, which form as the cheese is exposed to air; bloomy rinds, the soft cases found on Camembert or Brie; and washed rinds, created by spraying on brine, wine, beer, and usually found on stinky cheeses.

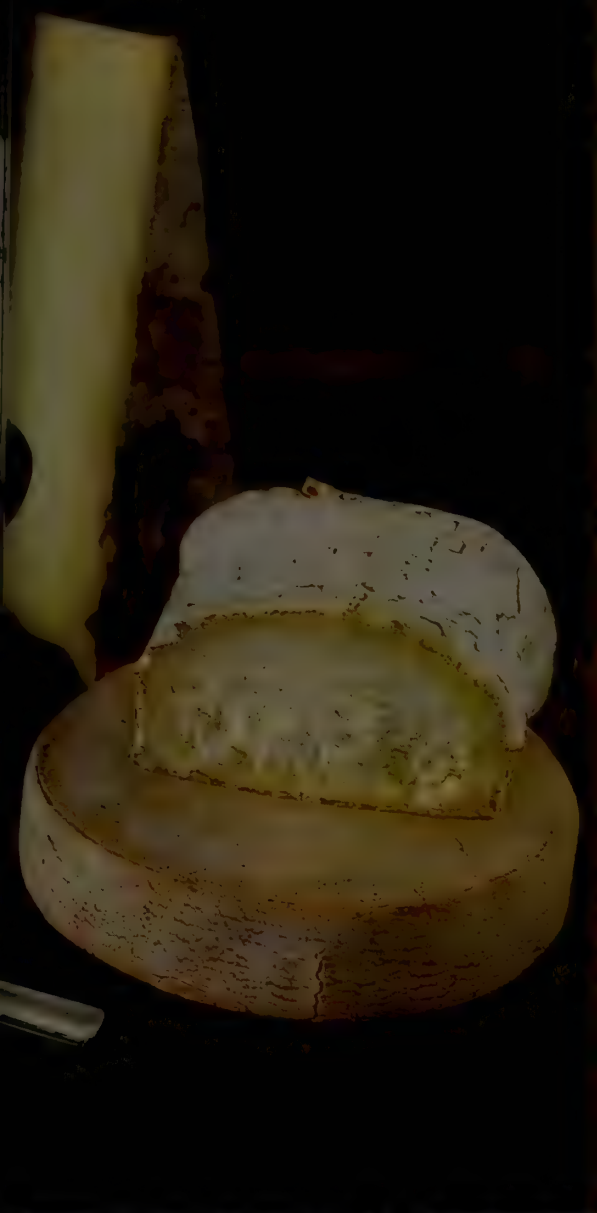
If you're not a connoisseur, start with goat cheese. It might surprise you. Many people think of it as the soft, creamy, bright-white Montrachet often served in a fancy restaurant along with a bit of apple and some walnuts. But goat cheese is as diverse as the more familiar cow's milk. Try a firm Mont St. Francis, from Capri.



PERFECT PAIRINGS

The sweetness and chalky texture of **Bonde de Gatineau** from Loire Valley, what this crisp **Kalin Cellars Sauvignon Blanc** demands





CHEESE TIPS

You'll enjoy cheese more if you're smarter about buying, serving, and storing it. Rob Kaufelt of Murray's Cheese in New York City offers these suggestions:

■ BUY FRESHLY CUT CHEESE.

Cheese, after all, is alive with bacteria, molds, and other microbes. It must be stored appropriately and sold when ripe. If you buy prepackaged cheese, beware of chemical additives, preservatives, and hydrogenated oils.

■ TASTE BEFORE YOU BUY IT.

No two handmade cheeses are the same. Weather and seasonal rainfall affect the flavor. A parmesan made in the spring might taste grassy, a winter cheese more nutty.

■ **SERVE AT ROOM TEMPERATURE.** You need to give the cheese time to develop its flavor.

■ **TO STORE, WRAP IN WAX PAPER AND COVER WITH PLASTIC WRAP OR FOIL.** Use new paper and plastic each time you open it. Fresh cheeses, such as a ricotta or chèvre, will keep five to eight days. Aged ones like parmesan or cheddar can be stored for a month or more.

PRICEY IMPORTS (From left) Spain's Valdeon Blue and Switzerland's Vacherin Fribourgeois, Buche des Causses, and Reblochon.

U.S. but offer great diversity in texture and flavor. Most widely available are the pecorinos (*pecora* is Italian for "sheep"). These aged cheeses, which vary in quality, are hard, salty, and hearty. Pecorino Toscano hails from Tuscany, Romano from Rome, and Sardo from Sardinia. Look for pecorinos that have been aged at least four months and check labels to make sure you're buying *pura pecora*, or pure sheep's milk. For something lighter, try brin d'amour, a soft, sweet Corsican cheese coated with fresh thyme and rosemary. It's delicious served with summer fruit and chilled white wine.

Cows'-milk cheese includes everything from a classic Double Gloucester Cheddar to the famous Stilton Blue, which comes from Central England and is often called the king of cheeses. It's hard to recommend just a few, but here are some that are a cut above what's found on the average dinner-party cheese plate. Cheddar lovers might sample Llangloffan, an aged Welsh cheese similar to a classic Cheshire. It's flaky without losing its buttery, luxurious taste. For a decadent treat, nibble Reblochon, a smooth, creamy cheese with a 75% butterfat content and a bloomy rind, from Alpine

in Greenville, Ind., available in fine shops and on Web sites. It's a strong aged cheese with a pale orange rind. Or try a hard, fruity chèvre noir from Quebec. The white paste encased in signature black wax is slightly different but similar to a full-flavored cheddar. If you still prefer Montrachet, trade up to an exquisite French Bûche des Causses. This cheese has a bloomy rind and a fluffy, mellow center.

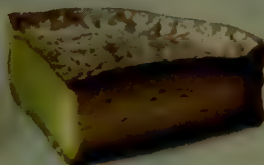
Sheep's milk cheeses are the least well-known in the

France. McCalman calls Reblochon the "bacon and eggs" of cheeses because of a subtle eggy flavor in the milk and a bacon-like saltiness in the final product. Even those who think they hate blue cheese can appreciate a tender, rich Bleu D'Auvergne from France. The taste is grassy with hints of wildflowers. Any one of the above will impress your guests and perhaps kindle a taste for cheese. It's one more way, as Max McCalman likes to say, to "spread the curd." ■

Grand Vin de Leoville du Marquis de Las Cases, a Bordeaux with cedar and black currant notes, is complemented by a hearty, nutty **Vacherin Fribourgeois** from Switzerland



The floral, milky **Durrus**, from County Cork, sets off the apricot and spice notes of this silky **Domaine Weinbach** Alsatian Riesling



Federal Figures At Your Fingertips

Profit data, career information, and more are just a mouse click away. **BY JAMES MEHRING**

THE U.S. government is a trove of economic statistics that can be incredibly helpful—provided you know how to find them. Government agencies keep increasing the amount of free information available to the public over the Internet. Below are some key sites.

■ BUREAU OF ECONOMIC ANALYSIS bea.gov

Topping the list of important data that the BEA generates is gross domestic product. The Commerce Dept. also calculates personal income, corporate profits, and the current-account balance—a quarterly snapshot of U.S. foreign trade and financial transactions.

With the economy picking up steam and the stock market barreling ahead, corporate profit data are handy for seeing which industries are performing best. Go to Interactive Data, found in the menu on the left, and choose the National Income & Product Accounts link. There are many NIPA tables, so it is easiest to use the index of keywords.

■ BUREAU OF LABOR STATISTICS www.bls.gov

This Labor Dept. site covers all aspects of the labor market, as is quickly evident from the cluttered home page. Given the lousy job market, you may be pondering a career change or wondering which jobs will be in demand

when your children graduate from college. Click on Occupational Outlook Handbook. It's under both Publications & Research Papers and Occupations. Here you can find detailed summaries on a whole spectrum of careers. Scroll down to Employment Projections (right-hand column) to see the 2000-2010 forecasts covering the entire labor market. You don't have a PhD or an MBA? The BLS breaks down job trends according to other levels of education, too.

Are you in charge of employee benefits and interested to see how your health insurance costs compare with sim-

ilar businesses? Take a look at the Employer Cost for Employee Compensation report. It's a quarterly review of wage and benefits costs by industry and company size. Get there by clicking the Employment Costs link under either the Business Costs or Wages, Incomes, & Benefits headings. The report is listed under Economic News Releases.

■ CENSUS BUREAU www.census.gov

The home page of the Commerce Dept.'s Census Bureau site provides easy access to the 2000 census figures. The data can be useful for business planning. Say you want to start a business in California and the target customer is households with incomes over \$50,000. Click on the American FactFinder link on the left-hand side of the Census Bureau page. At the FactFinder page, go to the Show Me menu. Scroll down to the Income and Poverty selection. Next, click on State—City and Town, and when the screen refreshes, select California. Hit Go. Up comes a table with median and per capita incomes for even the smallest towns in California. Detailed income, education, and population figures for individual cities are also available.

■ FEDERAL RESERVE federalreserve.gov

Any look at the economy would be incomplete without a visit to the Fed. If you want to know what the central bank sees the economy, the Beige Book is a good place to start. The report comes out two weeks before the FOMC gathers to discuss monetary policy. At the home page, just click Monetary Policy.

The Fed also tracks a plethora of interest rates. Looking to buy a house before rates get too high? Compare the best rates you receive with the weekly national average reported by the Fed. Just go to Economic Research & Data, and click on the statistics link.

If you are trying to save money to buy a house or get out of debt, the Fed can help there. The Federal Reserve Bank of Dallas has a beginner's guide, *Building Wealth*, on how to manage your finances. To get started, select the Publications & Education Resources link. The interactive site lets you plan a monthly budget or create an investment game plan, and it explains how to be smart about debt.





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AN ANTIDOTE FOR INFLATION ANXIETY

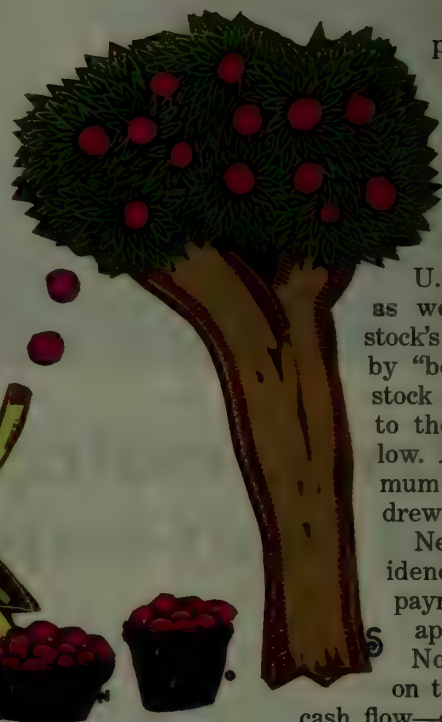
BY ROBERT BARKER rb@businessweek.com

IF THE THREAT OF FALLING bond prices didn't scare you in June, it should now. I don't say that just because the Lehman Brothers Aggregate Bond Index in July suffered its worst month since 1981. With President Bush now making it plain that war on terror means far higher government spending, budget deficits are inescapably headed up.

Megadeficits, in turn, raise the specter of inflation, a tempting way for Uncle Sam to ease his debt burden. Anyone who lived through the 1970s will recall the bond market welcomes inflation as much as pols relish tax hikes in election years.

Given this growing inflationary danger, it's only prudent to consider lightening up on bonds. Yet if you depend on interest payments from bonds to cover part of your living expenses, you will need to generate income from your portfolio in other ways. Money-market funds, now paying less than 0.9%, will hardly do. So I decided to see if I could build a portfolio of steady, dividend-rich stocks. With a hypothetical \$500,000 to put to work, I aimed to pick a diverse group of no more than 10 stocks capable of generating more income after taxes than intermediate-term municipal notes now pay.

First, I turned to a Standard & Poor's database filled with details on more than 4,500 stocks. With it, I set up a computer search with a long list of criteria. To survive the first cut, a company had to have reported a net profit over the past 12 months and be expected by Wall Street to remain profitable this year and next. It needed to have posted



positive cash flow from operations. Also required were a minimum stock market capitalization of \$1 billion and, to guard against foreign exchange-rate risk, a U.S. domicile. I was as well to see that the stock's volatility as measured by "beta," or how much the stock zigs and zags relative to the broad market, was low. All this, plus a minimum 3% dividend yield, drew 11 semifinalists.

Next, I looked to find evidence that the dividend payments are secure. I applied this harsh filter. No company could make the list unless its

cash flow—cash flow from operations minus capital spending—over the past year was higher than total dividend payments. In other words, I only wanted companies whose operations created enough cash to cover everything. This cut chemical giant DuPont, equipment manufacturer GATX, and natural gas distributor Nicor.

That left eight solid prospects (table). The group's stock prices have fluctuated on average half as much as the 500-stock index. Its dividend payments account for 40% of aggregate free cash flow, and the eight stocks yield an average of 3.7%. Does this mean a dividend cut is out of the question? No. Indiana-based NiSource, a natural gas utility, in July said that in November its annual dividend would fall 20%, to 92¢ a year, to bolster its credit status and bring its payout ratio in line with peers. Yet others, including ChevronTexaco, have recently raised their payouts. Still others may do so soon. BellSouth looks to be a reasonable candidate for a boost, with the total payout now 28% of free cash flow. A spokesman told me BellSouth's dividend has been under review since new, lower tax rates on dividends took effect.

Assume, though, that these eight stocks keep yielding 3.7%. With a \$500,000 portfolio and after a 15% tax, that yields \$15,725 in annual income. The same money in a year, AAA-rated munis paying the recent 2.6% average would earn \$13,000. Unlike stock dividends, which usually trend up, bond yields are fixed. Stocks court their own risk. But with inflation lurking, bond investors dependent on interest income should keep an open mind to dividend-paying stocks' higher rewards.

DIVIDEND-PAYING STOCKS: A SHOPPING LIST

COMPANY (SYMBOL)	PRICE*	ANNUAL DIVIDEND	DIVIDEND YIELD	DIVIDENDS AS A % OF FREE CASH FLOW	INDUSTRY
Alexander & Baldwin ALEX	\$29.02	\$0.90	3.1%	43%	Shipping
BellSouth BLS	25.50	0.92	3.6	28	Telecom
ChevronTexaco CVX	72.75	2.92	4.0	44	Oil & Gas
Fresh Del Monte Produce FDP	26.51	0.80	3.0	17	Food
Kellogg K	33.65	1.012	3.0	62	Food
Marathon Oil MRO	28.65	1.00	3.5	30	Oil & Gas
NiSource NI	19.22	0.92	4.8	76	Utilities
Verizon Communications VZ	35.03	1.54	4.4	36	Telecom

*Sept. 15 closing prices

Data: Company reports, Standard & Poor's, BusinessWeek

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CELL THERAPEUTICS: BIG BIOTECH PROMISE FOR THE LONG HAUL THE LOBSTERS ARE BUBBLING AWAY AT LANDRY'S RESTAURANTS PERFICIENT IS HELPING USERS WITH MORE KINDS OF SOFTWARE

BY GENE G. MARCIAL

Taking Aim at Cancer

Cell Therapeutics (CTIC) isn't expected to make money until 2007, but Edward Hemmelgarn, president of Shaker Investments, is buying into the small-cap biotech anyway. Shaker already owns 1.7 million shares. Cell is developing cancer treatments that are less toxic but more effective, he says. Hemmelgarn expects two pieces of good news: positive results from clinical trials on Xyotax, designed to outdo existing chemotherapy drugs such as Taxol and Taxotere, which generated sales of \$2 billion in 2002. And he expects Cell to name a drugmaker partner to market Xyotax, which has fast-track approval status from the FDA. Mark Schoenebaum of U.S. Bancorp Piper Jaffray, who rates Cell "outperform," expects the partnership to cover world rights for several products. Jaffray has done banking for Cell. Hemmelgarn sees Cell filing a new-drug application for Xyotax in early 2004 and marketing it in 2005. If Xyotax is O.K.'d, Hemmelgarn figures Cell could earn \$3 a share in 2007, "with significant growth thereafter." Cell has one FDA-approved drug, Trisenox, for acute leukemia. But most Trisenox revenues are from off-label sales for multiple myeloma and myelodysplastic syndrome. Expected Trisenox sales are \$24 million in 2003 "and by 2007 could exceed \$100 million," says Hemmelgarn. Cell stock rocketed from 7 in March to 14.75 in June before backtracking to 11.07 on Sept. 17. Hemmelgarn sees it at 30 in a year.



Landry's Restaurants: Riches from the Sea

Just stick to long-term, mid-cap value plays. So advises Roger Lipton, whose RHL Associates climbed 42% in 2001 and 7% in 2002, while the indexes slid way down. This year, only NASDAQ's 35% jump through Aug. 31 beat Lipton's 29% gain. The Standard & Poor's 500-stock index rose 14%. At first glance, Lipton's picks look humdrum—and they are: eateries and retailers. His latest find is Landry's Restaurants (LNY), No. 2 in seafood. It owns 279 restaurants, such as Joe's Crab Shack and Landry's Seafood House. Its stock is heating up—from 15 in March to 22 on Sept. 17. Lipton sees it hitting 30 in a year. Compared with its peers, says Lipton, Landry's is cheaper, based on book value,

cash flow, and assets. Landry's owns the land under most outlets. Lipton is impressed with Landry's swift integration of acquisitions, such as Chart House and Saltgrass Steakhouse, both acquired in 2002. Landry's cut ad costs, lifted earnings, and improved efficiency. It will open 24 new eateries in 2003, 25 in 2004. "We expect sales growth to accelerate," says Dennis Milton of S&P, who rates the stock "accumulate." Favorable food and labor costs, he adds, plus the rising popularity of seafood, should boost profitability. He sees 2003 earnings of \$1.78 a share on sales of \$1.1 billion and \$1.92 on higher sales in 2004, up from \$1.54 on \$894.5 million in 2002.



Perficient Dishes Out Efficient Tech Help

When the tech bubble burst, little-known Perficient (PRFT) tumbled—from 28 in 2000 to 5 now. But Perficient, which helps giants like IBM adapt their software to customers, is getting a boost as IT spending rebounds. Perficient is one of five companies that integrate IBM's WebSphere software with users' systems. WebSphere enables clients to handle e-commerce more efficiently. IBM will soon announce an extension of its Perficient pact. "Perficient is a play on outsourcing by software makers," says Brian Harvey of King Capital Management, which owns shares. He says more companies, including Microsoft, are using outfits like Perficient. "Some \$8 million of our estimated 2003 sales of \$28 million will come from IBM," says CEO John McDonald. Morton Meyerson, ex-president of EDS and now head of investment firm 2M, owns 20% of shares. Perficient's larger rivals include Accenture and Sapient. But Perficient, says Harvey, has more upside potential. Also, he adds, "with consolidation going on, Perficient is one attractive takeover target." He says it will earn 5¢ a share in 2003 and 12¢ to 14¢ in 2004. In 12 months, he sees the price hitting 5. McDonald declined comment on the takeover speculation.



BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. the magazine's publication day, usually Thursdays. See Gene on Fridays 1:20 p.m. EST on CNNfn's *The Money Gang*.

Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with the companies.

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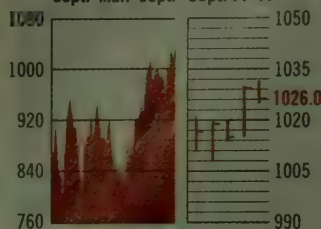
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Engineering the flow of communication

STOCKS

S&P 500

Sept. Mar. Sept. Sept. 11-17



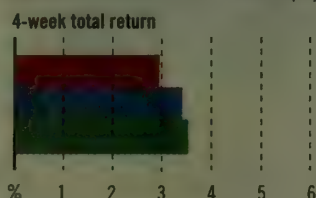
COMMENTARY

Equities turned in solid gains, despite lingering concerns about the outlook for corporate profits and the economy. But word from the Fed that a rise in rates was a long way off helped firm up bonds and moved stocks higher. For the week, the NASDAQ Composite, S&P 500, and the Dow rose 3.3%, 1.5%, and 1.3%, respectively.

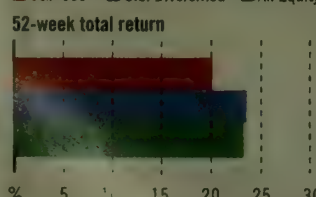
Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

Week ending Sept. 16
■ S&P 500 ■ U.S. Diversified ■ All Equity



Week ending Sept. 16
■ S&P 500 ■ U.S. Diversified ■ All Equity



Data: Standard & Poor's

U.S. MARKETS

	SEPT. 17	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1026.0	1.5	16.6	17.5
Dow Jones Industrials	9545.7	1.3	14.4	16.3
NASDAQ Composite	1883.1	3.3	41.0	49.5
S&P MidCap 400	525.0	2.0	22.2	22.9
S&P SmallCap 600	248.6	2.0	26.4	27.6
Wilshire 5000	9951.8	1.6	19.3	20.1

SECTORS

	SEPT. 17	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	590.6	1.6	8.9	7.0
BW Info Tech 100**	327.9	2.8	14.9	23.1
S&P/BARRA Growth	525.2	1.9	17.0	16.2
S&P/BARRA Value	497.4	1.1	16.2	18.9
S&P Energy	195.9	-2.4	7.0	10.1
S&P Financials	344.9	1.7	16.2	17.6
S&P REIT	105.8	0.2	16.5	11.6
S&P Transportation	181.8	2.1	5.9	8.8
S&P Utilities	109.0	0.2	11.5	13.6
GSTI Internet	140.5	4.9	88.1	108.8
PSE Technology	652.3	3.4	42.3	52.6

*Mar. 19, 1999=1000

**Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Comptr. Stge. & Perphs.	20.9	Internet Software 259.7
Electric Mfg. Svcs.	20.7	Comptr. Stge. & Perphs. 114.1
Internet Software	20.1	Divsfd. Metals & Mining 103.9
Tires & Rubber	19.0	Wireless Services 100.4
Communication Equip.	17.2	Internet Retail 92.1

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Japan	10.1	Technology	59.9
Technology	7.9	Communications	43.3
Diversified Pacific/Asia	6.8	Latin America	38.6
Latin America	6.4	Small-cap Growth	36.6
LAGGARDS		LAGGARDS	
Natural Resources	1.1	Miscellaneous	13.2
Financial	1.4	Domestic Hybrid	13.4
Miscellaneous	1.9	Large-cap Value	17.4
Large-cap Value	2.0	Large-cap Blend	17.5

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Apex Mid Cap Growth	19.5	PFds. Intnet. Ultrs. Inv.	197.5
ProFunds Ultra Japan Inv.	17.1	Jacob Internet	183.9
Reynolds	16.3	RS Internet Age	128.1
Winslow Green Growth	15.3	RS Information Age	121.6
LAGGARDS		LAGGARDS	
Accessor Growth Adv.	-15.4	Rydex Dynam. Vent. 100	-68.7
PFds. UKSh. OTC Inv.	-12.4	PFds. UKSh. OTC Inv.	-68.6
Rydex Dynam. Vent. 100	-12.4	Frontier Equity	-64.9
Potomac OTC/Short Inv.	-6.4	Potomac OTC/Short Inv.	-42.6

GLOBAL MARKETS

	SEPT. 17	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1004.3	2.0	1.8
London (FT-SE 100)	4293.0	1.0	8.1
Paris (CAC 40)	3393.9	2.0	10.1
Frankfurt (DAX)	3561.0	0.7	23.1
Tokyo (NIKKEI 225)	10,990.1	1.2	28.1
Hong Kong (Hang Seng)	11,140.1	3.1	19.1
Toronto (S&P/TSX Composite)	7613.6	0.6	15.1
Mexico City (IPC)	7746.5	0.2	26.1

FUNDAMENTALS

	SEPT. 16	WK. AGO
S&P 500 Dividend Yield	1.62%	1.62%
S&P 500 P/E Ratio (Trailing 12 mos.)	28.8	28.7
S&P 500 P/E Ratio (Next 12 mos.)*	16.7	16.7
First Call Earnings Revision*	0.57%	0.46%

TECHNICAL INDICATORS

	SEPT. 16	WK. AGO
S&P 500 200-day average	926.4	924.2
Stocks above 200-day average	82.0%	82.0%
Options: Put/call ratio	0.79	0.65
Insiders: Vickers NYSE Sell/buy ratio	4.99	4.69

WORST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Agricultural Products	-4.3	Health-Care Facilities
Multi-line Insurers	-3.8	Tires & Rubber
Motorcycles	-3.6	Housewares & Specits.
Specialty Appar. Retailers	-3.6	IT Consulting
Oil & Gas Exploration	-3.5	Tobacco

INTEREST RATES

KEY RATES

	SEPT. 17	WEEK AGO	YE
MONEY MARKET FUNDS	0.61%	0.61%	
90-DAY TREASURY BILLS	0.94	0.94	
2-YEAR TREASURY NOTES	1.61	1.63	
10-YEAR TREASURY NOTES	4.18	4.27	
30-YEAR TREASURY BONDS	5.09	5.16	
30-YEAR FIXED MORTGAGE	6.38	6.43	

†BancQuote

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR.
GENERAL OBLIGATIONS	3.80%	4.1
TAXABLE EQUIVALENT	5.43	6.1
INSURED REVENUE BONDS	3.87	4.1
TAXABLE EQUIVALENT	5.53	6.1

THE WEEK AHEAD

DURABLE GOODS ORDERS Thursday, Sept. 25, 8:30 a.m. EDT ▶ New orders for durable goods are forecast to have climbed 1% in August. That's according to the median forecast of economists surveyed by MMS International. In July, new orders also grew by 1%. A strengthening economy and low inventories should spark more strong gains in new orders and industrial production over the second half of the year.

INITIAL UNEMPLOYMENT CLAIMS Thursday, Sept. 25, 8:30 a.m. EDT ▶ New filings for state unemployment claims probably rose to 410,000 for the week ending Sept. 20.

Initial claims have returned to levels above 400,000, indicating that a turnaround for the labor market isn't here yet.

EXISTING HOME SALES Thursday, Sept. 25, 10 a.m. EDT ▶ Existing home sales in August very likely eased to an annual rate of 6 million, from a pace of 6.1 million during July.

NEW RESIDENTIAL SALES Thursday, Sept. 25, 10 a.m. EDT ▶ New single-family home sales in August probably declined to an annual rate of 1.15 million, from the 1.17 million pace in July. New home sales are

currently on track for another record year. However, as mortgage rates continue to creep higher, sales will begin to slow.

The *BusinessWeek* production index rose 199.4 for the week ended Sept. 6, up 4.6% from a year ago. Before calculation of the four-week moving average, the index dropped to 198.5.

BusinessWeek online

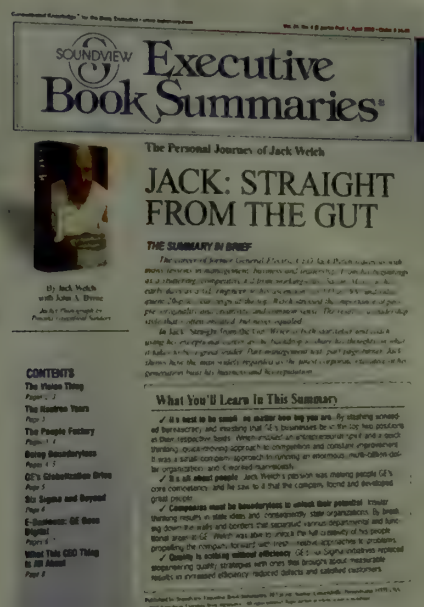
For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra

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Dust jacket photograph of Jack Welch by Timothy Greenfield Sanders.



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Index to Companies

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

A

ABB 63
Abercrombie & Fitch (ANF) **90**
Accenture (ACN) **92, 146**
Adam Street Partners **107**
Aeropostale (ARO) **90**
Affiliated Computer Services (ACS) **50**
Airborne (ABF) **98**
Alstom **63**
Altria (MO) **50**
Amazon.com (AMZN) **116**
American Airlines (AMR) **110**
American Eagle Outfitters (AEOS) **90**
America Online (AOL) **116**
Ameritrade Holding (AMTD) **98**
AOL Time Warner (AOL) **12**
Apple Computer (AAPL) **12, 116**
Arrowstreet Capital **134**
Artisanal Cheese Center **140**
AT&T (T) **98, 104**
AutoNation (AN) **16**
Avnet (AVT) **12**

B

Bain **92**
Bank of America (BAC) **106**
Bank One (ONE) **98**
Baring Asset Management **53**

Barnes & Noble (BKS) **104**
BellSouth (BLS) **144**
Best Buy (BBY) **98, 116**
BizRate **12**
Blockbuster (BBI) **12, 104**
BlueArc **107**
BMW 54
Boston Scientific (BSX) **50**

C

Canon (CAI) **133**
Capriole Farms **140**
CDW (CDWC) **12, 16**
Cell Therapeutics (CTIC) **146**
Cendant (CD) **110**
ChevronTexaco (CVX) **144**
Chez Panisse **140**
Chicago Cubs **66**

Chrysler (DCX) **12, 46, 54**
Cisco Systems (CSCO) **42**
Citigroup (C) **12**
Concentric Medical **82**
Continental Airlines (CAL) **110**
Covansys (CVNS) **12**
Cowgirl Creamery **140**
Cummins (CUM) **42**

D

DaimlerChrysler (DCX) **46, 54**
Dealtime **12**
Dell (DELL) **116**
Delta Air Lines (DAL) **110**
Deutsche Bank (DB) **54**
DirecTV (GMH) **94**
Domino's **98**
DuPont (DD) **144**
DWS **42**

E

eBay (EBAY) **12, 16, 116**
ECG **104**
EchoStar Communications (DISH) **98**
eFunds (EFDS) **12**
Electrolux **63**
Electronic Data Systems (EDS) **146**
Eli's Cheesecake **98**
Enron (ENRNQ) **12, 50**
E*Trade Group (ET) **12, 98**
Everbank **133**
Expedia (EXPE) **110, 116**

F

Federated Department Stores (FD) **90**
FedEx (FDX) **98**
Florida Marlins **66**
Ford (F) **46**
Forrester Research (FORR) **12, 48**
Freeman Spogli **12**
FreshDirect **116**

G

Galileo International (CD) **110**
Gartner Dataquest (IT) **12**
GATX (GMT) **144**
GeCAD Software **48**
Genentech (DNA) **82**
General Electric (GE) **50**
General Mills (GIS) **68**

General Motors (GM) **46, 116**
Goldman Sachs (GS) **36, 42**
Good Technology **24**
Google **12, 116**
GP Brinson Investments **134**
Grokster **94, 96**
Guidant (GDT) **82**

H

Handspring (HAND) **24**
Harris Poll **89**
Hasbro (HAS) **116**
Hay Group **92**
Hershey Foods (HSY) **68**
Hewitt Associates **92**
Hewlett-Packard (HPQ) **12**
Hollister (ANF) **90**
Honda (HMC) **46**
Hotels.com **116**

I

IBM (IBM) **12, 116, 146**
Ingram Micro (IM) **12**
Intel (INTC) **16, 116**
InterActiveCorp (IACIZ) **116**
IronPort Systems **108**

J

J.D. Power & Associates **54**
J.P. Morgan Chase (JPM) **42, 50, 58**
JetBlue Airways (JBLU) **116**
Johnson & Johnson (JNJ) **50**

K

Kansas City Royals **66**
KaZaA **94, 116**
Kellogg (K) **68**
Kingfisher Capital Management **146**
Kraft Foods (KFT) **68**
Krispy Kreme (KKD) **50**
Kroll **50**

L

Landry's Restaurants (LNY) **146**
Lehman Brothers (LEH) **144**
LendingTree (TREE) **116**
LimeWire **94, 96**
Limited Brands (LTD) **50**
Lipper (RTRSY) **138**
Lockheed Martin (LMT) **50**
Los Angeles Dodgers **66**

M

Mainstream Marketing Services **89**
Major League Baseball **66**
Mars 68
MasterCard **98**
McDonald Investments **36**
McGraw-Hill (MHP) **94**
MCI 104
Merrill Lynch (MER) **50**
MGM Studios (MGM) **116**
Microsoft (MSFT) **16, 48, 94, 116, 146**
Micro Warehouse **12**
Milwaukee Brewers **66**
Mitsubishi **54**
Mohr Davidow Ventures **107**
Montreal Expos **66**
Morgan Stanley (MWD) **36, 68**
Morpheus **94, 96**
Movielink **116**
Muriel Siebert **36**
Murray's Cheese **140**

N

Nabisco (KFT) **68**
Nestlé (NSRGY) **68**
Network Appliance (NTAP) **42**
Network Associates (NET) **46**
New England Consulting Group **68**
New York Jets **98**
New York Yankees **66**
Nicor (GAS) **144**
Nielsen/NetRatings **12**
NiSource (NI) **144**
Nissan (NSANY) **46**
Nokia (NOK) **116**
Northwest Airlines (NWAC) **12, 98, 110**
Novell (NOVL) **116**
NPD Group **90**

O

Oracle (ORCL) **12**
Orbitz **110**

P

Pacific Sunwear (PSUN) **90**
PalmSource **24**
Paramount Pictures **116**
PayPal (EBAY) **116**
Perficient (PRFT) **146**
Plaxo **116**

Political & Economic Risk Consultancy **58**
PriceGrabber.com **12**
PricewaterhouseCoopers **98**
Procter & Gamble (PG) **116**
Provident Financial (PVN) **98**
Prudential Securities (PRU) **68**

R

RAND **116**
Raymond James & Associates **138**
Reed Elsevier **94**
Research in Motion (RIMM) **24**
Restructuring Associates **112**
RFCO **107**
RHL Associates **146**
R.J. Reynolds (RJR) **50**
R.K. Hammer Investment Bankers **98**

S

Sabre (TSG) **110**
Salesforce.com **116**
Sapient (SAPE) **146**
Sears (S) **50, 98**
Seattle Mariners **66**
SEB 53
Sequoia Capital **107, 116**
7-Eleven (SE) **68**
Shaker Investments **146**
Sibson Consulting **92**
Siebel Systems (SEBL) **116**
Silver Lake Partners **107**
Sohu.com **116**
Sony (SNE) **116**
Southwest Airlines (LUV) **116**
Sprint (FON) **104**
Sprint PCS Group (PCS) **24, 98**
St. Louis Cardinals **66**
Standard & Poor's (MHP) **144, 146**
State Street Associates (STT) **134**
Stephens **39**
StreamCast Networks **96**
Sun Microsystems (SUNW) **116**
Symantec (SYMC) **48, 116**

T

Tampa Bay Devil Rays **66**

Target (TGT) **98, 104**
TD Waterhouse **98**
Technology Crossover Ventures **107**
Texas Rangers **66**
TGI Friday's **98**
ThinkingVOICE Network **107**
Thomson Venture Economics **107**
Ticketmaster **116**
Titan (TTN) **50**
Toshiba **12**
Toyota (TM) **46, 54**
Toys 'R' Us (TOY) **116**
Trend Micro (TMIC) **116**
T. Rowe Price (TRO) **116**
2M 148

U

United Airlines (UAL) **98, 110**
United Online (UNT) **116**
United Parcel Service **98**
Universal Studios (U) **116**
Urban Outfitters (U) **116**
USA Interactive (US) **116**
US Airways **98**
U.S. Bancorp Piper (USB) **48, 146**

V

Verizon Communications (VZ) **116**
Visa **98**

W

Wachovia Securities **138**
Wal-Mart Stores (W) **116**
Walt Disney (DIS) **116**
Warner Bros. (AOL) **116**
Warner Music Group **94**
Washington Mutual **98**
Windham Capital Management **134**

Y

Yahoo! (YHOO) **12, 116**

Z

Zandl Group **90**
ZoneLD **104**

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Earth Share

LESSONS FROM THE GRASSO AFFAIR

Richard A. Grasso's resignation as chairman of the New York Stock Exchange came with stunning swiftness. It is appropriate. The spectacular size of his compensation package was unseemly at best. But more important, it was unacceptable for someone who was also regulating members of the exchange. Some elements of Grasso's compensation were just plain wrong. The most egregious example was the \$5 million bonus that Grasso received for his job performance after September 11. While the ability of the exchange to start functioning again after the terrorist attacks was remarkable, so was the performance of the firefighters, police, and thousands of other New Yorkers.

But even beyond Grasso's poor judgment and missteps, it's clear that the exchange needs to significantly change the way it is run (page 36). The first order of business is to ensure that the NYSE, at a minimum, meets the same standards of corporate governance as the companies that list on the exchange. That means publicly disclosing the full compensation of top executives. If such a rule had been in effect, it would have been much harder for Grasso's pay package to sneak by under the radar until its announcement.

And just as public companies have been forced to reinforce the independence of their boards of directors, the NYSE needs to do the same. The number of so-called public or outside di-

rectors on the board has to be increased, and they must come genuinely from areas outside of financial service-related industries.

The NYSE also needs to resolve issues that go beyond those of the typical public company. One of Grasso's problems was that he wore two hats—in one he looked for the members of the NYSE, who own the exchange, the other he was their regulator, determining listing requirements and monitoring violations of trading rules, including insider trading. The two roles necessarily conflict since actions that are in the public's interest may not be what the members of the exchange want—and it certainly seems that Grasso had an incentive to lean toward the members, who paid him that enormous sum.

For that reason, the whole question of whether the NYSE and the securities industry in general can regulate itself needs to be reexamined. That won't happen overnight. The industry has a long history of self-regulation in the securities industry, which has always argued that it knows best how to catch bad behavior. But as the Grasso case shows, self-regulation typically guarantees conflicts of interest. In the end, it may turn out that the NYSE needs a separate regulatory organization, distinct from the exchange itself, much like the NASD. That is a better way to go.

TRADE TALKS: THE RIGHT NEXT STEP

At least for the moment, the progress toward further trade liberalization has run aground. The latest round of global trade talks, held in Cancun, broke down in mid-September, as developed and developing countries could not agree on what to do about agricultural subsidies, rules for foreign investment, and other issues. In effect, the developing countries banded together and drew a line in the sand, saying that they would be not be willing to further open their economies unless they got a better deal.

In part, the opposition to trade concessions is not surprising, given the stage of the global business cycle. The world economy may be picking up speed (page 42), but it's tough to overcome political opposition when Europe is still stuck in a slump, Japan is just escaping from 13 years of stagnation, and the U.S. is running trade deficits of staggering proportions.

But the halt in trade negotiations should also be viewed as a challenge to the industrialized countries. For one, the latest events come after several years of growing opposition to globalization, starting with the huge demonstrations in 1999 at the Seattle meetings of the World Trade Organization. At the same time, developed countries are still walling off imports of low-end goods, such as textiles and agricultural products, that represent promising areas of export

growth for many developing nations. It may be that a measure of subsidies for farmers in developed countries can be justified on the grounds of self-sufficiency in food. But cultural subsidies that total \$300 billion—an amount as large as the economy of Taiwan—are damaging to global productivity and growth.

That's why the U.S., Japan, and Europe, in part, must roll back their agricultural subsidies. There's no economic reason why President George W. Bush should have signed an enormous expansion of the farm-subsidy program into law last year. And there's no good economic reason why the EU is still spending an estimated \$100 billion annually on direct subsidies to farm producers.

The advantages of a global economy far outweigh its disadvantages, which is why *BusinessWeek* has always supported free trade and globalization. That's exactly why it may be time to focus on the objections of the developing countries, which seem well-founded. Unlike in the past, when developing countries resisted opening their markets in part to protect the local elites, there's little doubt now that many of them are getting the short end of the stick. Free trade is the way to move forward—the global benefits are simply too great. But the developed countries need to accept that free trade should be the guiding principle.

Business Week

October 6



HOW SOME
ENGINES
AGED (P.89)



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IS WAL-MART TOO POWERFUL?

Page 100

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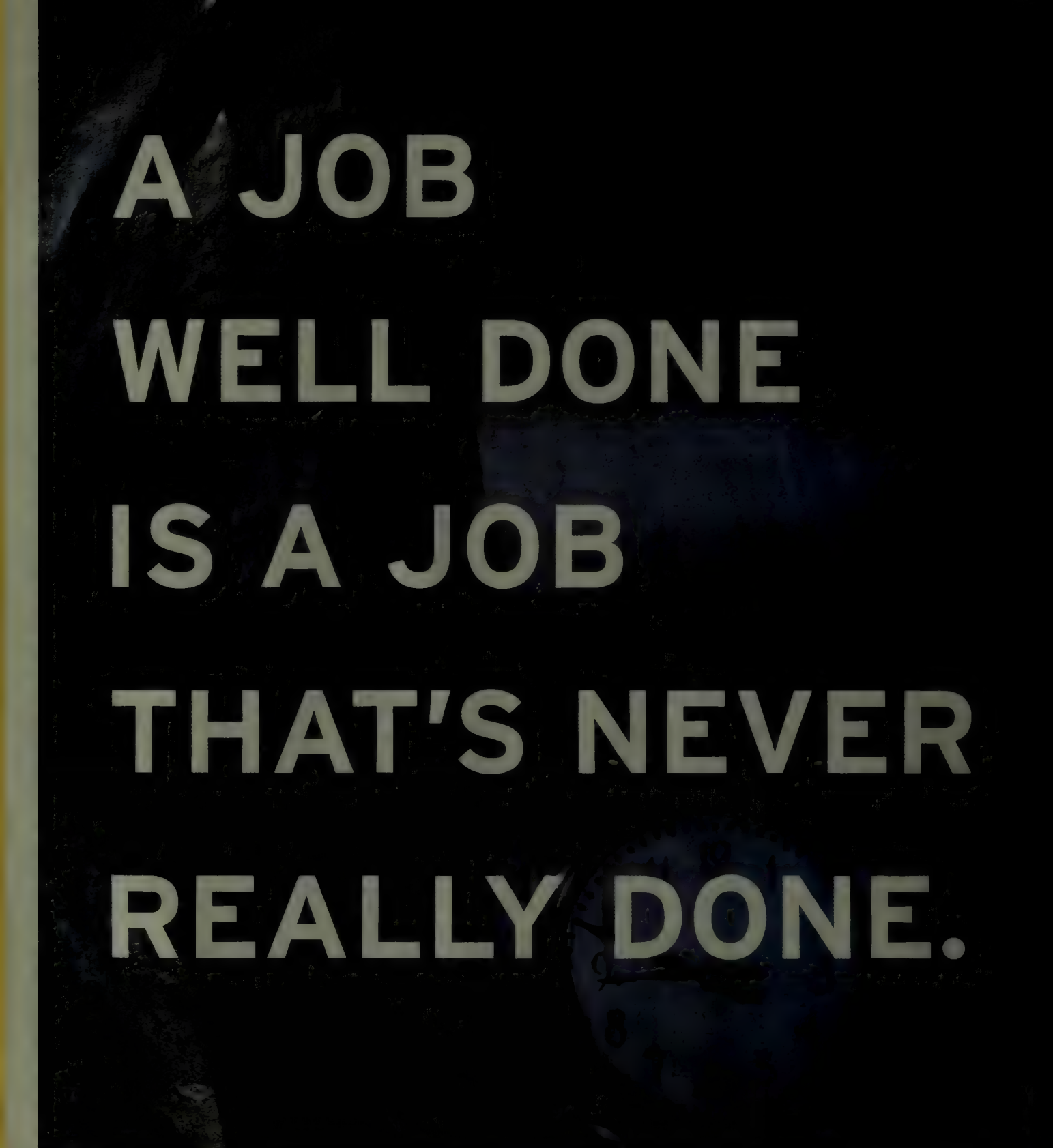
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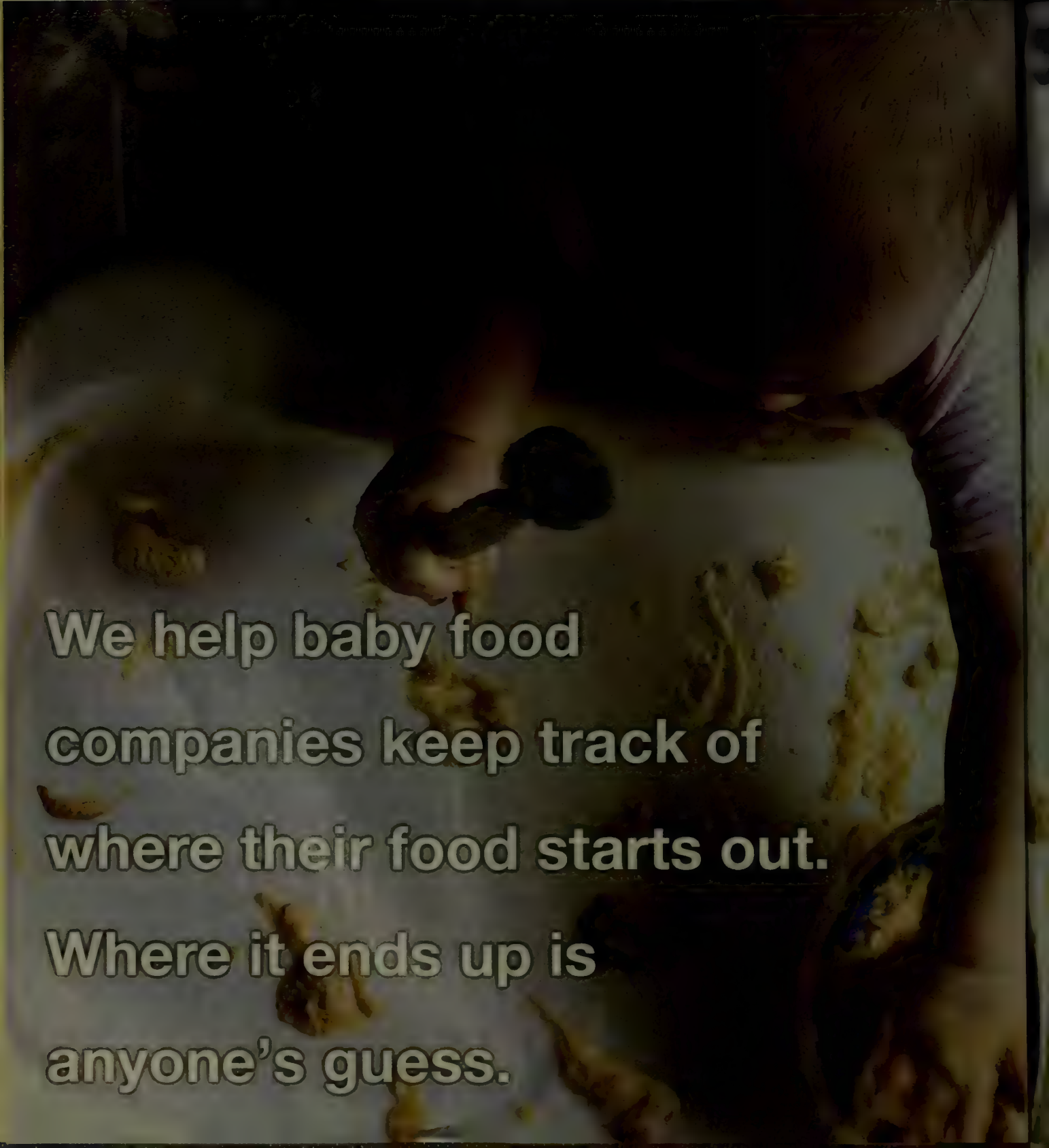
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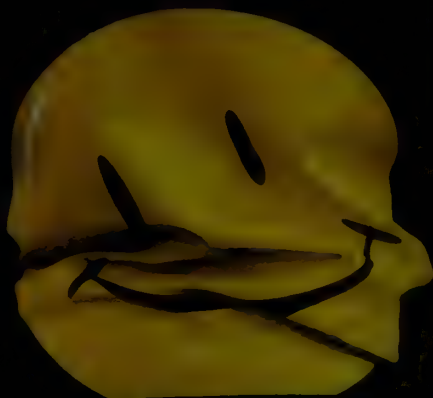
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100

COVER

The Wal-Mart Way: A virtuous business model and its perverse consequences

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Cover Story

100 Wal-Mart: Too Power

Its "everyday low prices" strategy has made Wal-Mart the most successful retailer ever. But its dominance has created unintended problems—for suppliers, workers, communities, and even American culture

News: Analysis & Commentary

44 New Broom at the Big Board

Can John Reed bring real change to troubled NYSE?

47 Commentary: The NYSE

Reforming the exchange could back

48 Energy: A Fragile Reprieve

Prices have fallen—at least for now

50 Toyota Reinvents the Hybrid Wheel

The new Prius is luring buyers

51 Mr. Kozlowski Goes to Court

How both sides will argue the case

52 Commentary: Motorola

An outsider CEO may be what it needs

54 The Information Age's Toxic Garbage

Cracking down on discarded PCs

56 Tobacco-less Row

R.J. Reynolds' latest layoffs cut deep

58 In Biz This Week

International Business

62 Autos: Asian Invasion

The Japanese and Koreans make a European push, picking up market share

64 Europe: Pirated Music

Can music-swapping really be stopped?

67 China: Troubled Banks

Another reason Beijing won't revalue

68 Commentary: France

Anti-Americans vs. Anti-Anti-American

134

GENRY'S SECRET
Why the architect loves his software

129

STREET SCOURGE

Eliot Spitzer on the record

International Outlook
Korea's reformers up the ante

Economic Analysis

Economic Viewpoint
The labor time bomb

Economic Trends
and U.S. jobs; college tax breaks;
entitled employees

Business Outlook
A trimmer, healthier Corporate
America is set to start hiring
any: A long, slow turnaround

Government

Washington Outlook
Presidential primary goes national

Commentary: Campaign 2004
National security: The Democrats' risky
bets on Bush

Science & Technology

Genentech's Medicine Man
Investors are cheering CEO Levinson, a
chemist with a keen business sense

Developments to Watch
Fighting fires with water balloons; stem
cell and brain tissue; heart-valve repair
catheter

Information Technology

Wildstrom: Technology & You
Time for a new high-tech manifesto

How Some Searches Are Rigged
The growth of "paid inclusion" is
jeopardizing the integrity of results

Commentary: Cell Phones
The industry can recharge itself

Media

Time Warner's Plan B
Dick Parsons is rolling with the
changes

Sports Biz

Did the Bengals Claw Taxpayers?
The local official is suing over funding for
the new stadium in Cincinnati



72

BIOTECH BOUNTY

CEO Art Levinson got
Genentech on the
mend. Now he's on the
cusp of a rare
pharmaceutical trifecta

Marketing

112 Gap: Still a Fashion Victim?
Despite an overhaul, sales figures for the
chain are downright dowdy

115 Stemming the Spam
California has the toughest law in the
country—but will it do the job?

Finance

122 Bankers Are Biting Their Nails
They're starting to feel the pain of rising
rates—and it could get much worse

124 Tech IPOs Run Out of Tricks
Wall Street can't pump up prices any
more, so deals are way off—and smaller

126 Commentaries: A Weaker Dollar
Pro: Letting the greenback drop will
curb the U.S. trade gap, reduce the
dangers of deflation, and defuse
protectionism in Congress
Con: A falling dollar will scare off foreign
investors, slow growth in the short run,
and do zilch to boost stagnant
productivity in some industries

Legal Affairs

129 A Conversation with Eliot Spitzer
'There has been a fundamental change
that will last for some time'

People

134 Frank Gehry's High-Tech Secret
The architect wants to share the
software that makes his designs doable

Personal Business

142 Zooming in on Digital Zooms
Panasonic and Olympus are the best of a
growing list of cameras

144 Food: Next-Generation Jerk
Jamaican influences find their way into
U.S. kitchens and restaurants

147 Amid Turmoil, Funds Take Off
Third-quarter equities rallied up a
storm, and even bond funds held fast

152 Q&A: John Hathaway
Why he's betting the gold rally will last

154 Forget The P-E
Try the "EV" to size up a company

158 Footnotes
Married women live longer; dividends;
golf in Britain; serving U.S. wine

160 The Barker Portfolio
Don't get hooked on Applied Materials

162 Marcial: Inside Wall Street

Features

13 UpFront

20 Editor's Memo

22 Readers Report

24 Corrections & Clarifications

26 Books: Christensen and Raynor:
The Innovator's Dilemma

31 BusinessWeek Best-Seller List

164 Figures of the Week

166 Index to Companies

168 Editorials

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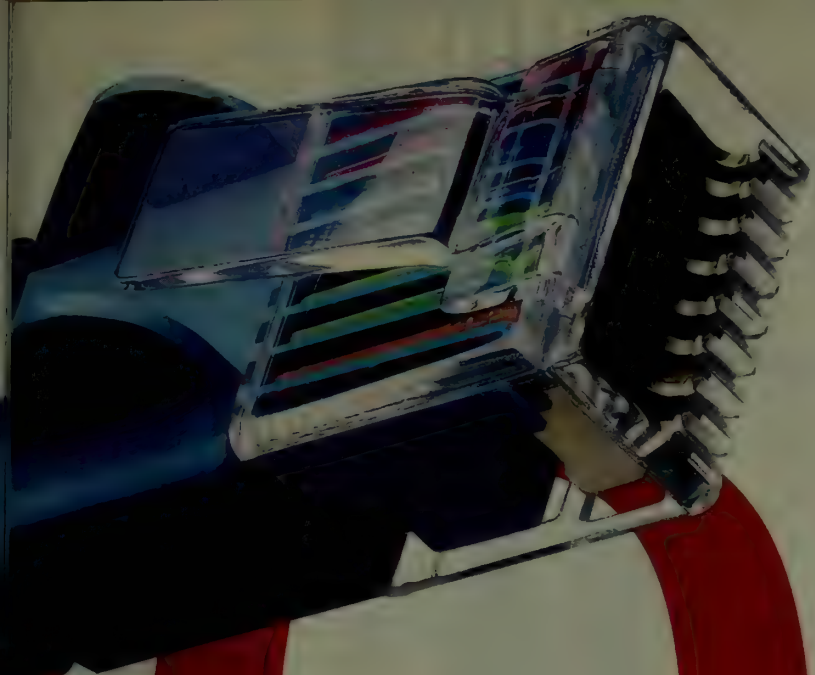
A large, blue, glossy fiber optic cable enters from the right side of the frame, loops around the word "XEROX" in a large, red, serif font, and exits towards the bottom left. The cable has a visible texture and a bright highlight along its length.

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Staying on Top of a Shifting Market

The race does not always go to the swiftest—and that seems to apply to the fast moving stocks that first fueled the current market rally. Now, those stocks have cooled, and smart investors are repositioning their portfolios to catch the next rising wave



Global Finance Reining in Risk

Emerging markets are raising substantial amounts of capital once again, thanks to reforms that have stabilized their economies and increased transparency for investors



Special Report: Network Security

Worms, viruses, bugs, and spam have spurred many experts to start pushing for concrete reforms, some quite radical to shore up Internet security. Also: The vulnerability of U.S. infrastructure systems, and how Wi-Fi and instant messaging may open the door to trouble

Understanding the Mutual-Fund Scandal

New York Attorney General Eliot Spitzer has launched a probe of the industry, but the complexity of the allegations has left some shareholders scratching their heads. Here is a primer to help investors understand his crusade against late trading and other abuses

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A woman with short brown hair, wearing a denim jacket, stands in a field with green bushes and a stone wall in the background. She is looking upwards with a thoughtful expression. A yellow text box is overlaid on the image.

"I'd rather have a
cleaner environment,
but I can't imagine
me without my car."

▲ Steph Willen/Independent Film Producer

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JP Front

"We will not allow you to litter the Information Superhighway with e-mail trash."

—California Governor Gray Davis, signing the country's toughest anti-spam law

ED BY IRA SAGER

BY PARCELS MEET SPATCHES FEDEX

WORDS "early retirement" "severance" hardly excite workers. Except at **FedEx**'s best division, air express. There, more than 20% of 100,000 salaried workers are expected to snap up early-

ping consultant in Memphis. The early-retirement package lets workers in their 50s get full pensions and medical benefits as if they were retiring at 60. The severance package offers \$10,000 plus four weeks' pay for each year of service, up to a maximum of 72 weeks. "It's a heck of a kiss goodbye," says analyst Donald Broughton of **A.G. Edwards & Sons**. FedEx won't disclose how many

workers have signed on, but it says: "The acceptance rate has been quite good."

FedEx can afford such largesse because technology-driven productivity has soared. Customers can now track packages

online, for example, rather than asking FedEx to do it. Broughton figures the offers will shave up to \$190 million in costs annually—and give new life to area bingo halls.

—Charles Haddad



ment or severance packages before a Sept. 30 deadline. "The word on the street here is that everyone's excited about the offer," says Mason Kauffman, a former FedEx exec and a ship-



HAND OVER FIST
Terminator III brought him almost \$30 million

TINSELTOWN

A-List Money Isn't Going to Arnold

WITH THE RECALL ELECTION back on, it's a good thing Arnold Schwarzenegger collected nearly \$30 million to reprise his Terminator role. That's because Hollywood's A-list money is not supporting his gubernatorial bid. Instead, Arianna Huffington seems to be raking in Hollywood dough.

Left-leaning Huffington is more palatable for Hollywood Dems than GOP Arnold. Among her backers: **Miramax** chief Harvey Weinstein and producer Lawrence Bender both gave the legal limit of \$21,200. Lesser amounts have come from Barbara Streisand and Dustin Hoffman, among others. Why back a long shot? In a town where relationships are key, the people you know may be more important than the chances of winning the election. "I always support my friends," Weinstein says.

Arnold isn't being snubbed completely. Jerry Perenchio, chairman of **Univision Communications**, and Hollywood lawyer Jake Bloom gave at least \$20,000. And on Sept. 21, director Ivan Reitman hosted a fund-raiser—but no stars showed. Will Arnold snub those who stiffed him? "He's a big star," says Tom Pollock, former **Universal Pictures** chairman and Arnold backer. "People still will do business the way they always have." —Ron Grover

THE BIG PICTURE

ENGINEERING ON THE CHEAP The average annual salary for an electrical engineer with 10 years' experience and living in:

\$20,000 \$40,000 \$60,000 \$80,000

JOSE \$106,400

SHANGHAI

MEXICO CITY

BOMBAY

U.S. California Employment Development Dept.



APPLIANCES

NO MORE SCRUB-A-DUB-DUB?

FOR DIRTY POTS AND PANS, old-fashioned elbow grease is out. **Procter & Gamble** has come up with a motorized scrub brush to tackle after-meal messes. Dubbed the Dawn Power Dish Brush, the 11.5-inch gizmo is topped with rotating bristles and takes four AA batteries. The \$8 brush appears on Oct. 6.

The Dish Brush comes from the inventors who dreamed up the Crest Spin-Brush, now the best-seller in its class, with nearly \$200 million in annual sales. Dawn brand manager Ernesto Levy calls the Dish Brush "a



breakthrough innovation."

Veteran dishwashers are skeptical. Linda Cobb, author of *Talking Dirty with the Queen of Clean*, says buyers will tire of a gadget that has to be cleaned after the dishes are done. "It will get shoved to the back of the cupboard," she says. Mark Lopez, who loads the dishwashers every night at **The Palm** restaurant in New York, says: "I don't see why you need this.... Just press a button to use the dishwashing machine." And that's from a man who knows.

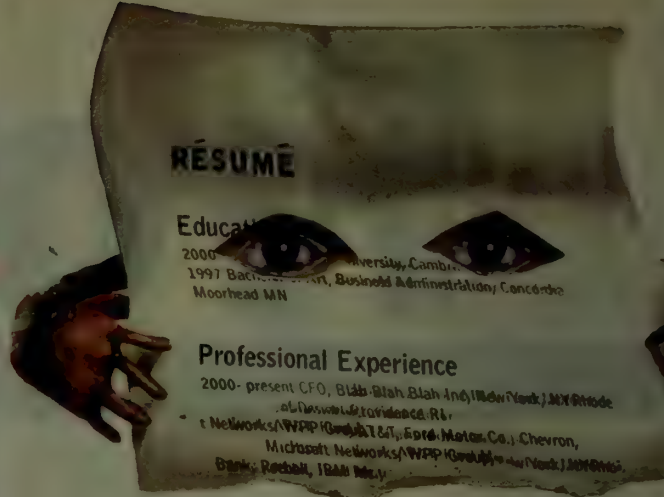
—Robert Berner

THE LIST

Institutional investors say they have the least confidence in the prospects of:

- 1 Qwest
- 2 Ford
- 3 TXU Energy
- 4 Sears
- 5 Computer Associates
- 6 Lucent Technologies
- 7 Interpublic Group
- 8 Schering-Plough
- 9 Sun Microsystems
- 10 Safeway

Survey of 3,000 institutional investors
Data: Brendan Wood International



JOB MARKET

DON'T HEDGE YOUR AGE Forget about puffed up job titles and phantom degrees. The late ruckus in résumé land: a new caginess about age. In this foul market, **more managers are doing a kind of résumé-plasty**, lopping 10 years of job experience off here and nipping dates off degrees there, say employment experts. Why? Job seekers are scared of being seen as too experienced (expensive) or too old (40-plus). What's ironic is that the educated young have been the ones hit hardest. Since April 2000, employment among the 55-to-65-year-old set has jumped 6%. Gen X's rate has dropped 3%—more sharply than any other group since the Korean War.

—Michelle Co

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FACE TIME

MICHAEL USEEM



WHEN AN 'F' STANDS FOR FRIGID

Cost accounting, mergers, acquisitions—and sub-zero survival? Add the last to management guru **Michael Useem's** list of things every budding CEO should know. The Wharton prof—known for his offbeat leadership exercises—is taking 18 MBA students to Antarctica in January for a physically grueling, 10-day exploration trek. “We are a kind of experiment in leadership,” says Useem.

He promises “after-action reviews” to help participants apply their Antarctic lessons at the office. The thinking: Exposing MBAs to decision-making under duress and comparing their experiences with those of explorers such as **Ernest Shackleton** clarifies how to take action back home.

Filmmaker **David Stone** is in talks with Public Broadcasting Service to develop a five-part program based on the South Pole exploits and on past Useem adventures. They may be entertaining, but time will tell if they're of much use in the corner office. —**Brian Hindo**

SHOW BIZ

PLAY IT AGAIN, EVERYBODY

IN LOOKING to buy **Vivendi Universal**, **NBC** says that one of the properties it covets most is **Universal Studios'** movie library. No wonder. Sales and rentals of DVDs have become a great way for Hollywood to dust off the classics and boost the top line. U.S. sales and rentals of DVDs are set to hit \$14 billion this year, vs. \$9.4 billion in box-office receipts, predicts **PricewaterhouseCoopers**.

Much of that is coming from the studios' film catalogs: 1,200 movies made before 1997 have been released on DVD so far this year, vs. 351 new movie, according to the newsletter *DVD Release Report*. “DVDs have become a collectibles business,” says **Craig Kornblau**, president of Universal Studios Home Video.



SCARFACE
hello to my little DVD

Hollywood's recycling efforts are now generating nearly as much hoopla as the original premieres. To help promote the Sept. 30 release of the 20th-anniversary DVD of *Scarface*, a cult favorite among hip-hoppers, Universal Studios threw a big bash in New York attend-

ed by star **Al Pacino** before releasing the flick in theaters in 10 cities. “The disks are breathing new life into catalog films that nobody was buying on videotape,” says **Ralph Tribbey**, editor of *DVD Release Report*. What better sequel for Hollywood?

—**Tom I**

STREET TALK

HOT JOBS ON THE BOTTOM RUNG

WALL STREET IS starting to hang out “Hiring” signs again after two dismal years that squeezed 39,000 jobs out of the securities industry. Stocks have rallied, and retail investors are finally coming back. The **Securities Industry Assn.** expects industry earnings to double this year, hitting \$15 billion.

But the job rebound isn't across the board. Firms “are hiring selectively,” says compensation consultant **Alan Johnson**, of **Johnson**

Associates. The cheaper the hire, the better. Fresh college grads are in demand to do grunt work for bankers and analysts. Some banks are bulking up in growth segments, such as **Citigroup's** job additions in its retail arm.

The new hires could put firms in a better position to grab business. **Lehman Brothers** and **Bear Stearns**, traditionally strong in bonds, have added equity staff. “They should be poised to take advantage of any increase in activity,”

says **Anton Schutz**, manager of **Burnham Financial Services Fund**. If they do it right, the nimble hirers could see a rise in market share and stock price. —**Brian Hindo** and **Emily Thornton**



THE STAT

65

Percentage of companies in the S&P 500 with underfunded pension plans. Only 37% of technology companies have pensions that are in the hole, vs. 87% of energy companies.

Data: Analyst's Accounting Observer

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Spectrum Income	★★★★
Value	★★★★★

Funds were rated against the following numbers of funds in U.S.-domiciled categories for the overall rating and the 3-, 5-, and 10-year (if applicable) periods as of 8/31/03. Blue Chip Growth and Growth Stock were rated among 933, 933, 603, and 190 large growth funds. Equity Income was rated among 645, 645, 507, and 180 large value funds. Value was rated among 645, 645, and 507 large value funds. Equity Index 500 was rated among 1,060, 1,060, 740, and 233 large blend funds. International Growth & Income was rated among 693 and 693 foreign stock funds. Short-Term Bond was rated among 192, 192, 166, and 75 short-term bond funds. Spectrum Income was rated among 136, 136, 111, and 36 multisector bond funds.

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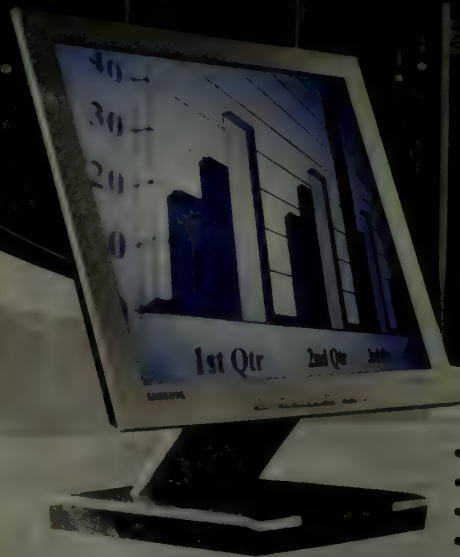
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†For funds with at least a 3-year history, a Morningstar Rating™ is based on a risk-adjusted return measure (including the effects of sales charges, loads, and redemption fees) with emphasis on downward variations and consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% 4 stars, the next 35% 3 stars, the next 22.5% 2 stars, and the bottom 10% 1 star. Each share class is counted as a fraction of one fund within this scale and rated separately. The Overall Morningstar Rating™ is derived from a weighted average of the performance figures associated with a fund's 3-, 5-, and 10-year (if applicable) Morningstar Rating™ metrics. Morningstar Rating™ is for the retail share class only; other classes may have different performance characteristics. Blue Chip Growth received 4, 4, and 5 stars for the 3-, 5-, and 10-year periods, respectively. Equity Income received 4, 4, and 5 stars for the 3-, 5-, and 10-year periods, respectively. Equity Index 500 received 3, 3, and 4 stars for the 3-, 5-, and 10-year periods, respectively. Growth Stock received 5, 4, and 5 stars for the 3-, 5-, and 10-year periods, respectively. Value received 4 and 5 stars for the 3- and 5-year periods, respectively. International Growth & Income received 4 stars for the 3-year period. Short-Term Bond received 4, 4, and 3 stars for the 3-, 5-, and 10-year periods, respectively. Spectrum Income received 4 stars for the 3-, 5-, and 10-year periods.

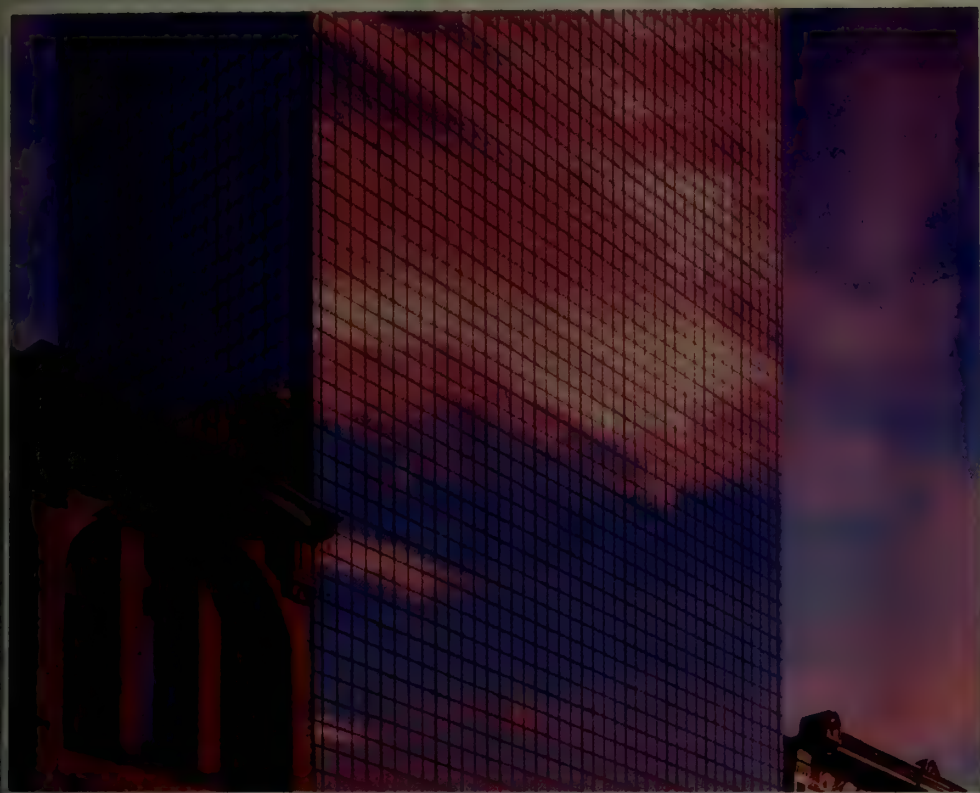
**As of 6/30/03, the funds' total expense ratios versus their Lipper category averages for retail funds were: 0.76% and 0.96% for Growth Stock and Blue Chip Growth versus 1.80% for the large-cap growth funds category; 0.78% for Equity Income versus 1.57% for the equity income funds category; 0.35% for Equity Index 500 versus 0.85% for the S&P 500 index objective funds category; 1.25% for International Growth and Income versus 1.96% for the international funds category; 0.94% for Value versus 1.63% for the multi-cap value funds category; 0.79% for Spectrum Income versus 1.43% for the general bond funds category; and 0.55% for Short-Term Bond versus 0.96% for the short investment-grade debt funds category. All funds, including separate share classes, more than six months old as of 6/30/03, are included in this study. (Source for Lipper expense data: Lipper Inc.) T. Rowe Price Investment Services, Inc., Distributor. MPOW067680

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Why the Bold New Look

A redesign is a milestone in the life of any magazine. Our last redesign came 20 years ago in a seminal, even radical, makeover created by B. Martin Pedersen. His design, in particular our bold cover with its distinctive red, white, and blue logo, was remarkably successful—and widely imitated by magazines around the world. We've updated that design a number of times in the intervening years as we expanded our coverage and added new features.

We decided about a year ago that it was time for another complete redesign of the magazine. With *BusinessWeek's* art director, Malcolm Frouman, leading the way, our senior editorial team and our art, photo, and production staffs brainstormed numerous approaches. The goal for all of us was to make the magazine bolder, more contemporary, and more user-friendly.

We are fortunate to be working with two fine designers, Maryjane Fahey and David O'Connor of the FaheyOConnor firm in New York. Their new concept for *BusinessWeek* places a greater emphasis on typography, photography, illustration, and more accessible informational graphics to create a dramatic, sleek look.

To get from concept to printed page, you can't just flip a switch. For the past nine months, Frouman and his team have been working with Fahey and O'Connor to fine-tune *BusinessWeek's* formats section by section. In preparation for the launch, our art department has tested each week's issue for the past month in the new format, comparing the old look and the new, page by page.

"While we hope to surprise our readers with a powerful new design, they will still find *BusinessWeek* engaging and accessible," says Frouman. "The covers will be more dynamic, the photography more compelling, and the informational graphics more useful than ever. We've taken a very good magazine and made it even better."

EASIER TO FIND WHAT YOU'RE LOOKING FOR. As you look through this week's issue, you'll also see an expanded Up Front section and the return of the Personal Business moniker in the back—a name and line of coverage *BusinessWeek* pioneered more than 50 years ago. It's easier to find what you're looking for, too, with page numbers for all the stories we highlight on our covers, a streamlined contents page, plus interior tables of contents in News: Analysis & Commentary and Personal Business, and a new weekly navigation guide for *BusinessWeek* Online.

We have introduced new typefaces throughout the magazine. Headlines are in Benton Gothic and Fenway Display, a new typeface created expressly for *BusinessWeek* by type designer Matthew Carter. For the body text of stories, we



are using Fenway Roman, also designed by Carter. And we've even increased the type size for greater legibility.

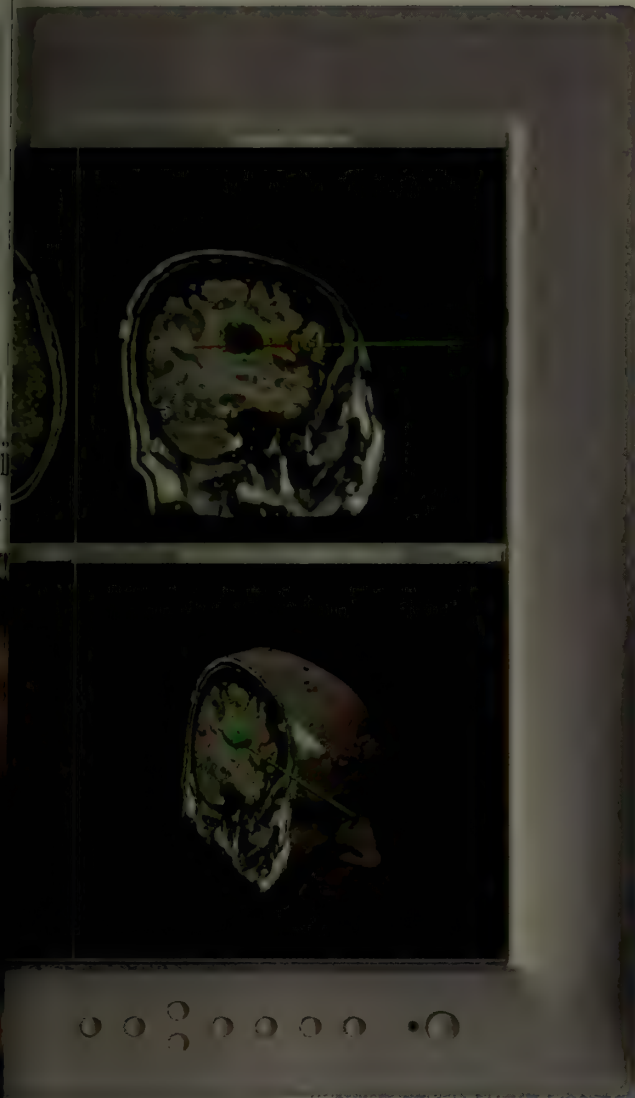
The redesign comes at a significant moment for *BusinessWeek*: We are now entering 75th anniversary year, which we will celebrate next September. So it's a good time to take a fresh look at the best-selling business magazine in the world.

We hope you like the new design as much as we do. Bon Voyage!

TEAM REDESIGN *BusinessWeek's* Art Director Malcolm Frouman (right) worked with Maryjane Fahey and David O'Connor

Stephen B. Shepard

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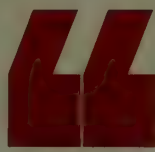
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Excessive pay reminds me of college drinking contests... whoever drinks the most without passing out is admired.

—Allen Price
 Mountain View, Calif.

HOW MUCH DID DICK GRASSO DESERVE?

WHAT I FIND MOST IRRITATING about New York Stock Exchange Chairman Richard A. Grasso's reward package is that it disregards the work done by all the people behind the scenes ("The \$140,000,000 man," Cover Story, Sept. 15). They didn't share in the loot, although they shouldered the burden. If he's so deserving, perhaps they should all call in sick one day to let him run the place by himself. Why does Grasso deserve a \$5 million bonus for September 11? Many people have to work miracles on a daily basis because "that's what they get paid for." Unfortunately, overpaid CEOs aren't held to the same standard.

—Paul Wetor
 Milwaukee

MR. GRASSO AND HIS BOARD just didn't exhibit the judgment you'd expect from otherwise astute businesspeople. Pick a number. Grasso should have earned maybe some reasonable multiple of tens of millions. Greed showed a compensation payoff attempt that is despicable, and borders on immoral at a time when regulatory governance, and the NYSE corpo-

rate governance, should be at its peak. What is also sad is that Grasso, and indirectly, the Board, were willing to push through at all costs. Grasso resigns in grace after 36 years. Let's not feel sorry for him, though. I'm sure he'll spend it with his buddies from the NYSE Board.
 —I.G. Fredericks
 Austin, Tex.

LIBERAL RAILINGS against "tax cuts for the wealthy" usually leave me feeling quite dyspeptic. However, after reading about Grasso's compensation plan, I had to concede that they may have a point. Perhaps Congress should consider a rate for unearned income.

—John G. Crockett
 White Plains, N.Y.

THE \$140 MILLION MAN has resigned, but his board still seems to be in a fog about how he came by that tidy sum. Here's a scenario that puts the figure in perspective: Assume that at the end of his year of employment at the NYSE, Grasso received a sum X into his retirement account. This deposit started accruing interest at a rate of 8% per year. After the second year, he received another depo-

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CORRECTIONS & CLARIFICATIONS

In "Reform: Who's making the grade" (Management, Sept. 22), the calculation of 158 accounting restatements that occurred in the first half of 2003 should have been attributed to Huron Consulting Group.

which was 8% more than the one the year before. This deposit also earned interest at 8%. And so forth, every year thereafter. For all of these deposits to be worth \$140 million today, after 35 years of employment, the initial deposit X would have had to be \$292,184, which it obviously wasn't. Two important conclusions can be drawn: The later deposits Grasso received no doubt by far exceeded his regular compensation. And second, do not underestimate the power of compounding interest, even at just 8% per year.

—Christoph Steinbruchel
Clifton Park, N.Y.

AMERICANS BELIEVE it is their birthright to earn any amount of money, even if it is more than they can spend intelligently in their lifetime. This game of excessive pay reminds me of college drinking contests, in which whoever drinks the most without passing out is admired.

—Allen Price
Mountain View, Calif.

WHAT A FINE ROLE MODEL for the financial-services industry.

—Ken Stanley
Citrus Heights, Calif.

TIME FOR ELIOT SPITZER to take another look at the NYSE.

—Dave Wells
Wilkes-Barre, Pa.

PRODUCTIVITY WILL SUFFER WHEN THE BOOMERS BOW OUT

"STILL GETTING STRONGER" (News: Analysis & Commentary, Sept. 15) pre-

dicts long-term productivity growth based on the increasingly effective use of information technology and tighter management of labor. You ignore an important element of productivity: the increasing skill and experience of aging boomers. Baby boomers are entering their most productive age range, and currently make up a disproportionately large segment of the population. In addition, according to the Bureau of Labor Statistics, they are the only age group with an increasing labor-force participation rate during the current recession.

Ignoring the baby boomers' effect on productivity could be serious, because it's short-lived, not long-term. In 2010, baby boomers will start retiring in droves—when we will need higher productivity to help support them in retirement.

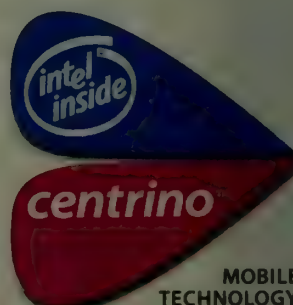
—Edward A. Br...
New...

MILITARY PERSONNEL —AND MILITARY PENSIONS

I AM VERY UNCOMFORTABLE with reading elsewhere that military members of the special forces operate commonly without uniform, as during the early days of the Afghanistan operation ("Outsourcing war," Special Report, Sept. 15). Now, private military companies (PMCs) perform largely, but not exclusively, in-theater support missions. Field support is, of course, a military function, as is training and security. Clearly, that makes PMCs a legitimate military target. Also, when the government foots the operational bill for some coalition forces, does that make those coalition forces mercenaries in some eyes?

—Vic Kar...
White Pine, N...

AS FOR BILLY J. GRAY's military pension, your article indicated that a veteran with 20 years' service would receive 50% of old salary. Use of precise terminology gives full insight into the military compensation structure yields a very different



accurate accounting. Mr. Gray's pension is 50% of his base pay, excluding all allowances (such as those for quarters and subsistence). In my case as a Commander, O-5, with 22 years active service, my pension amounts to about one-third of my total active duty compensation. For members with specialty pay for flying, hazardous duty, etc., pension at 20 years can easily amount to less than one fourth of their salary, which is half the amount your article would lead the reader to believe.

—James H. Martin
Alexandria, Va.

SAFE PLACE FOR CHILDREN TO SURF

COLUMN "Putting e-limits on your kids" (Technology & You, Sept. 15) is both timely and informative. Readers should know that President Bush signed into law legislation to create a child's section of the Internet, where kids can go to gain the benefits of the Internet in a safe environment. I invite your readers to learn more by visiting Smithsonian.kids.us, the site of many kids.us sites to come.

—John M. Shimkus (R-Ill.)
House of Representatives
Washington

DO YOU BUY THE BELLS' BROADBAND SOB STORY

HOW TO GET U.S. BROADBAND up to speed" (Information Technology, Sept. 8) says the U.S. is lagging behind in the deployment of broadband services because of poor, unfortunate Bell operating companies are saddled with regulations that are not imposed on the cable industry. Roger O. Crockett has bought the propaganda that the Bells have been feed-back regulators across the country (by the way, most aren't buying). This is a common tactic of the Bells—running to regulators when they are getting beaten in the marketplace. The Bells have been willing to make the capital investments

required to upgrade their antiquated legacy networks. Cable has invested billions in upgrading their networks and has reaped the rewards in doing so, capturing the lion's share of the broadband residential market. Cable made the investment with no guarantee of profits from regulators and entirely with private risk capital.

—Ron McMillan
Houston

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Innovate or Die

THE INNOVATOR'S SOLUTION: Creating and Sustaining Successful Growth

By Clayton M. Christensen and Michael E. Raynor; Harvard Business School Press; 304pp; \$29.95

Harvard Business School professor Clayton M. Christensen sent many executives and managers at established companies into a funk with his 1997 book, *The Innovator's Dilemma*. He showed that an upstart with an innovation that disrupts existing business models can beat out big guys

nearly every time—be it Intel Corp. with the microprocessor in the 1970s or steel mill Nucor Corp. with a way to reuse scrap in the 1990s. What's more, he said, venerable companies seal their doom by doing just what they're supposed to do: pleasing their most valuable customers. There seemed no way out.

Christensen's accessible and rigorous new book, written with Deloitte Research Director Michael E. Raynor, provides a survival manual for corporate managers. *The Innovator's Solution* makes a credible case that established companies can defy the odds after all, provided they offer disruptive new products of their own. By channeling innovation into fast-growing new areas, posit Christensen and Raynor, businesses will be able to reel in new customers, time after time.

The authors don't pretend that overcoming the innovator's dilemma will be easy. The essential problem is that companies naturally improve their products, so they can earn better profits. But invariably at some point, an upstart with a new technology or low-cost process appears, and as it in turn makes improvements, it eats into the established company's core market. The lowly transistor, for example, killed the vacuum tube, while PCs, once derided as toys, snuffed minicomputers and currently threaten servers from the likes of Sun Microsystems Inc. Yet there's no intrinsic reason, the authors assert, that even large businesses can't seize the day themselves.

How? Although *The Innovator's Solution* is less a how-to book than a how-to-think book, Christensen and Raynor offer systematic approaches for treating innovations in a new way. Instead of just turning a new idea or technology into a better mousetrap, they suggest ways to transform it into a product that completely changes the game, capturing brand-new customers and thus producing much higher growth. Procter & Gamble Co., for instance, does more than simply offer "new and improved" toothpaste. In 2001, it launched Crest Whitestrips, a home tooth-whitening product that created a new market of 10 million users with nearly \$300 million in sales.

Just as crucial, say Christensen and Raynor, is making sure corporate processes help rather than hobble a new idea. They suggest a twofold approach: First, early on, managers should talk about a possible innovation as something that could threaten their core business—if someone else were to do it first. Research indicates that threats, rather than opportunities, mobilize resources much faster. Then, once the project is under way, it should quickly be spun off into an independent group that isn't beholden to the company's established ways of dealing with more incremental new ideas. Hewlett-Packard Co. did this with its highly successful inkjet printers, for instance, and so did Johnson & Johnson with the angioplasty instruments and portable blood-glucose meters that it acquired.

There's also good advice on how to keep a project on track once it's launched. In stark contrast to the "get big fast" mantra of the 1990s Internet boom, the authors counsel that companies should be "impatient for profit but patient for growth." While the profit imperative is obvious today, the authors say too many companies forget the second part. When bad times hit, they lose faith, and, instead of giving a new product the time to gather speed, they force it into a seemingly more certain, established market. This, they say, results in certain failure.

The only problem with the book is a paucity of examples showing how established companies have overcome the dilemma and capitalized on new innovations themselves. The authors offer some hypothetical cases,

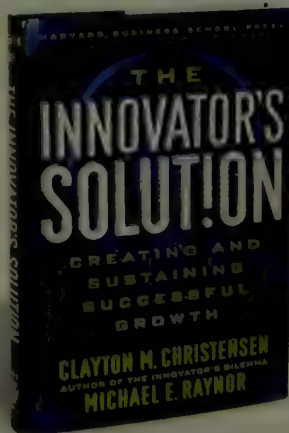
such as how Xerox Corp. might use its promising printing technologies to undercut HP's inkjet business. But they are entirely convincing. In fact, the authors admit that "no company has been able to build an engine of disruptive growth and keep it running and running." Surely if this were possible to do, as Christensen and Raynor believe, a few companies would have done

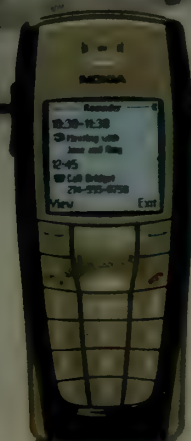
Nonetheless, the book makes

**How Big Biz
can be as
nimble—and
competitive—
as startups
so often are**

a strong case that there's not much choice but to try. Christensen's research indicates that the odds of creating a successful growth business jump from 6% to 37% when a disruptive strategy is used instead of an incremental one. Even if *The Innovator's Solution* offers no guarantees, its clear-eyed advice comes at just the right moment for an economy still struggling to recover. ■

—By Robert D.





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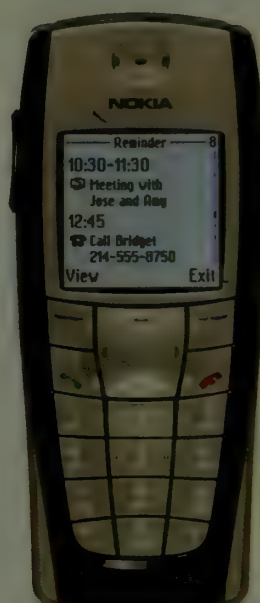
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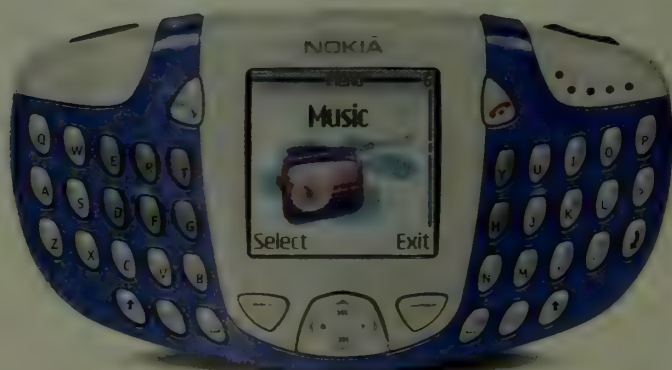
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The BusinessWeek Best-Seller List

HARDCOVER BUSINESS BOOKS			LAST MONTH	MONTHS ON LIST	PAPERBACK BUSINESS BOOKS			LAST MONTH	MONTHS ON LIST
1	GOOD TO GREAT Jim Collins (HarperBusiness • \$27.50) <i>How run-of-the-mill companies make the leap to excellence.</i>	1	23	1	FAST FOOD NATION Eric Schlosser (HarperCollins • \$13.95) <i>The implications of the burger-and-fries culture.</i>	1	19		
2	EXECUTION Larry Bossidy, Ram Charan (Crown Business • \$27.50) <i>Translating business strategies into results.</i>	2	15	2	NICKEL AND DIMED Barbara Ehrenreich (Owl Books • \$13) <i>An undercover investigation into the daily struggles of the working poor.</i>	3	8		
3	WHAT SHOULD I DO WITH MY LIFE? Po Bronson (Random House • \$24.95) <i>Overcoming confusion to find your true calling.</i>	4	8	3	THE INTELLIGENT INVESTOR, REVISED EDITION Benjamin Graham, with Jason Zweig (HarperBusiness • \$19.95) <i>The classic explanation of "value investing," with new material.</i>	2	2		
4	REEFER MADNESS Eric Schlosser (Houghton Mifflin • \$23) <i>The underground economy in porn, pot, and migrant labor.</i>	3	4	4	THE TIPPING POINT Malcolm Gladwell (Back Bay • \$14.95) <i>What turns an idea into a hot trend.</i>	4	20		
5	24 DAYS Rebecca Smith, John R. Emshwiller (Harper Business • \$25.95) <i>Two Wall Street Journal reporters' account of the Enron fiasco.</i>	—	1	5	WHAT COLOR IS YOUR PARACHUTE? Richard Nelson Bolles (Ten Speed • \$17.95) <i>The 2003 edition of the enduring job-search bible.</i>	5	11		
6	THE FIVE DYSFUNCTIONS OF A TEAM Patrick Lencioni (Jossey-Bass • \$22) <i>Ending behavior that obstructs teamwork.</i>	6	14	6	REAL ESTATE LOOPHOLES Diane Kennedy, C.P.A., Garrett Sutton, Esq. (Warner • \$16.95) <i>Tax and legal knowhow.</i>	6	5		
7	PURPLE COW Seth Godin (Portfolio • \$19.95) <i>Astonish your customers, says this marketing guru.</i>	5	4	7	REAL ESTATE RICHES Dolf de Roos (Warner • \$17.95) <i>Why buildings are better investments than stocks.</i>	7	22		
8	THE ONE MINUTE MILLIONAIRE Mark Victor Hansen, Robert G. Allen (Harmony Books • \$19.95) <i>Chicken soup for the investor.</i>	10	11	8	THE E-MYTH REVISITED Michael E. Gerber (HarperBusiness • \$16) <i>How a systematic approach can lead to small-business success.</i>	8	23		
9	MAKING THE MOST OF YOUR MONEY Jane Bryant Quinn (Simon & Schuster • \$30) <i>An updated financial primer.</i>	—	5	9	THE RICHEST MAN IN BABYLON George S. Clason (Signet • \$6.99) <i>Save 10% of what you earn, then pay your bills.</i>	9	18		
10	ADVENTURE CAPITALIST Jim Rogers (Random House • \$26.95) <i>Insights about the future of the global economy from a world traveler.</i>	—	3	10	IT'S NOT HOW GOOD YOU ARE, IT'S HOW GOOD YOU WANT TO BE Paul Arden (Phaidon • \$7.95) <i>An ad man's aphorisms on success.</i>	12	2		
11	LEADERSHIP Rudolph W. Giuliani (Talk Miramax • \$25.95) <i>Hizzoner speaks.</i>	12	11	11	RICH DAD'S RETIRE YOUNG RETIRE RICH Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$17.95) <i>Plan ahead.</i>	10	20		
12	THE POWER OF FULL ENGAGEMENT Jim Loehr, Tony Schwartz (Free Press • \$26) <i>Apply the rigors of the gym to work and personal life.</i>	7	5	12	HOW TO MAKE MILLIONS IN REAL ESTATE IN 3 YEARS STARTING WITH NO CASH Tyler G. Hicks (Berkley • \$14) <i>Make way, Donald Trump!</i>	13	7		
13	THE 5 PATTERNS OF EXTRAORDINARY CAREERS James M. Citrin, Richard A. Smith (Crown Business • \$22.95) <i>Tips on managing your work life, from two executive recruiters.</i>	—	1	13	THE POWER OF FOCUS Jack Canfield, Mark Victor Hansen, Les Hewitt (Health Communications • \$12.95) <i>Zoning in on achievement.</i>	—	4		
14	HUG YOUR CUSTOMERS Jack Mitchell (Hyperion • \$19.95) <i>It's the personal touch that counts.</i>	8	2	14	INVESTING IN FIXER-UPPERS Jay P. DeCima (McGraw-Hill • \$18.95) <i>This old house.</i>	15	5		
15	THE 21 INDISPENSABLE QUALITIES OF A LEADER John C. Maxwell (Thomas Nelson • \$17.99) <i>The personal traits necessary to inspire the rank and file.</i>	—	1	15	HOW TO MAKE MONEY IN STOCKS William J. O'Neil (McGraw-Hill • \$12.95) <i>Picking winners, by the founder of Investor's Business Daily.</i>	—	7		

LONG-RUNNING BEST-SELLERS

HARDCOVER BUSINESS BOOKS	THE 21 IRREFUTABLE LAWS OF LEADERSHIP John C. Maxwell (Thomas Nelson • \$22.99)	THE 7 HABITS OF HIGHLY EFFECTIVE PEOPLE Stephen R. Covey (Fireside • \$14)
HOW TO MOVE MY CHEESE? Spencer Johnson (Putnam • \$19.95)	PAPERBACK BUSINESS BOOKS	RICH DAD'S CASHFLOW QUADRANT Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$17.95)
WHY? Stephen C. Lundin, Harry Paul, John Christensen (Hyperion • \$19.95)	RICH DAD, POOR DAD Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$15.95)	RICH DAD'S GUIDE TO INVESTING Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$17.95)
KNOW YOUR STRENGTHS Marcus Buckingham, Donald O. Clifton (Free Press • \$27)	GETTING TO YES Roger Fisher, William Ury, Bruce Patton (Penguin • \$14)	HOME BUYING FOR DUMMIES Eric Tyson, Ray Brown (Wiley • \$21.99)
BREAK ALL THE RULES Marcus Buckingham, Curt Hamman (Simon & Schuster • \$27)	THE ONE MINUTE MANAGER Kenneth Blanchard, Spencer Johnson (Berkley • \$12.95)	THE 9 STEPS TO FINANCIAL FREEDOM Suze Orman (Three Rivers • \$14.95)
WING FANS Ken Blanchard, Sheldon Bowles (Morrow • \$20)		

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BY STEPHEN H. WILDSTROM

It's Time for a New High-Tech Manifesto

Five years ago this month, I wrote a column calling for a Computer Users Bill of Rights. The manifesto, based on the work of IBM researcher Clare-Marie Karat, argued that the No. 1 priority for tech companies should be making products easy to use. How well have they done? A look back finds major progress, but also plenty of new problems.

Seven of the 10 points laid out by Karat, a usability expert at the Thomas J. Watson Research Center in Hawthorne, N.Y., dealt one way or another with the difficulty of installing and running hardware and software. While computers are still harder to use than they should be, tech companies have done much better in these areas.

Judging by what I hear—and don't hear—from readers, the basic job of getting computers, accessories, and programs up and running is no longer a big source of hassles. Nor are incomprehensible error messages a cause of much complaint. "We've made some real improvements," says Karat. "We're not there yet, but I'm proud of the work we have done." The biggest change, she says, is that usability issues are now considered central to the process of developing software or hardware, rather than as something to be fixed up just before a product ships.

IT SEEMS TO BE A RULE OF LIFE, however, that when we make progress against one evil, another rises to take its place. Five years ago, the most threatening thing you were likely to encounter on your computer was a Windows message informing you that someone or something had performed an "illegal operation." Today, our e-mail inboxes overflow with junk, much of it promoting illegal schemes of one sort or another and some of it truly vile pornography. We are warned almost daily of vulnerabilities in software and of scary-sounding worms and viruses designed to exploit them. We're no longer sure whether the PC on the desktop is a useful tool or a dangerous intruder in our homes. It's no accident that Karat has shifted the focus of her research from traditional usability issues to protecting the privacy of computer users.

The successful attack on 1998's problems of hardware and software usability was important in making computers and the World Wide Web the true mass-market products they became during the Internet boom. It will take similar progress to assure the public that their computers are safe from hackers, their e-mail inboxes safe from junk, and their online information safe



from thieves. Failure could prevent the liftoff of wireless services and e-commerce that I believe will be at the heart of a new spurt of high-tech growth.

Five years ago, a small number of companies—Microsoft, Apple Computer, Hewlett-Packard, and a few independent software publishers—took up the challenge. Today's problems are beyond the reach of even the biggest corporations. Still, they should provide far more leadership in the fight. Microsoft, after an embarrassing series of Windows security

holes, needs to convince us that "trustworthy computing" is more than a public-relations slogan. The industry should leave behind a fruitless Washington argument over just what spam will be permitted and get to work—focusing on the technical fixes needed to stop it. And service providers and Web-site operators must, at long last, pay more than lip service to consumers' demands that their privacy be protected.

Customers should be due that as a matter of right. But it's also good business, because a failure

Techdom's fate rides on the fight against viruses, spam, and ID theft

to address these concerns could cripple the industry just as it's recovering. The gains in usability created by plug-and-play installations that actually work and operating systems that rarely crash were well worth the effort required. The next phase is more difficult, but every bit as necessary and potentially even more rewarding. ■

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BY JEFFREY E. GARTEN

Will All Those Jobs Ever Come Back?

Most everyone knows we're in a jobless recovery, with a 6.1% rate of unemployment and nearly 3 million people losing their jobs in the past two years. There is also a consensus among mainstream economists that conventional government policies, especially the kind of massive tax cuts and big deficit spending instituted by President George W. Bush, will usher

in a standard business recovery that will eventually generate lots of jobs and lower the unemployment rate. We'd better be prepared for that consensus to be wrong. There is a good chance that many of the jobs will never come back.

GOING EAST. One reason is the growing labor efficiency that allows American companies to accomplish more with fewer people. Such productivity growth averaged 2.6% in 1996-2002, compared with 1.4% in 1980-95. Moreover, it soared to nearly 7% in the second quarter this year. Looking ahead, even more labor-saving techniques will be embedded in every sector of the economy, spurred by advances in information technology and by continuous pressure for cost-cutting.

A second megatrend is the explosive growth of outsourcing to China, India, and elsewhere. The problem involves not just the transfer abroad of traditional manufacturing by companies such as Ford and Intel but also the relocation of such operations as software design, tax analyses, and financial research by the likes of Microsoft and Citigroup.

Third, financially strapped state governments are cutting back on education and job training. This is happening just as retiring baby boomers are about to leave big gaps in the numbers of workers with important technical skills.

Not everyone is alarmed. Stephen Roche, Morgan Stanley's chief economist, says that productivity growth in services is not as high as economists allege. Harvard Business School's Michael Porter told me that companies' enthusiasm for outsourcing could wane once they understand the full costs of lower productivity and loss of control over crucial aspects of their business. Meanwhile, Glenn Hubbard, former chairman of the Council of Economic Advisors, has recently written that we are experiencing nothing more than the historic process of shedding old jobs and creating new ones.

I hope Hubbard is right. But even if he is, I fear that America could be heading for an employment debacle that won't be overcome—at least at tolerable social cost—if everything is left to the market or to current government programs that are scattered and underfunded. To me, the big risks are in doing too little rather than too much.

What steps should be taken? Washington should start by rationalizing the spaghetti bowl of federal, state, and local job

training programs and put someone with exceptional clout in charge. It should ensure its education goals and training programs are well-funded, even if that means measures as politically difficult as imposing a gasoline tax.

The government should create more effective partnerships with the business community to equip workers for specific industries that are likely to expand in the years ahead. These include health care, where millions of nurses for our aging population will be needed; education, where highly qualified K-12 teachers will be in severely short supply; and new industries, such as homeland security.

Washington should also focus heavily on helping small and medium-size companies by reducing regulatory red tape and

the cost of litigation. It's in this part of the economy, and not in footloose multinational companies where there's the highest potential for more good jobs.

The Administration is right to be tough on countries that subsidize their exports or violate intellectual property rights. But the big problems are homegrown, and the government should strongly resist protectionist pressures. This includes a proposal to raise tariffs on Chinese imports in order to

pressure Beijing to revalue the yuan. Ditto for attempts by state governments, such as New Jersey, to ban all outsourcing on state contracts. Equally misguided are proposals from some Democratic Presidential aspirants under which companies that refrain from moving operations abroad would be awarded tax breaks.

Admittedly, I don't see anything on the near-term horizon showing that our political or business leaders see the problem in its proper dimensions. But if my concerns are only half right, it won't be too long before they'll have to. ■

Jeffrey E. Garten is dean of the Yale School of Management and author of *The Politics of Fortune: A New Agenda for Business Leaders* (jeffrey.garten@yale.edu).

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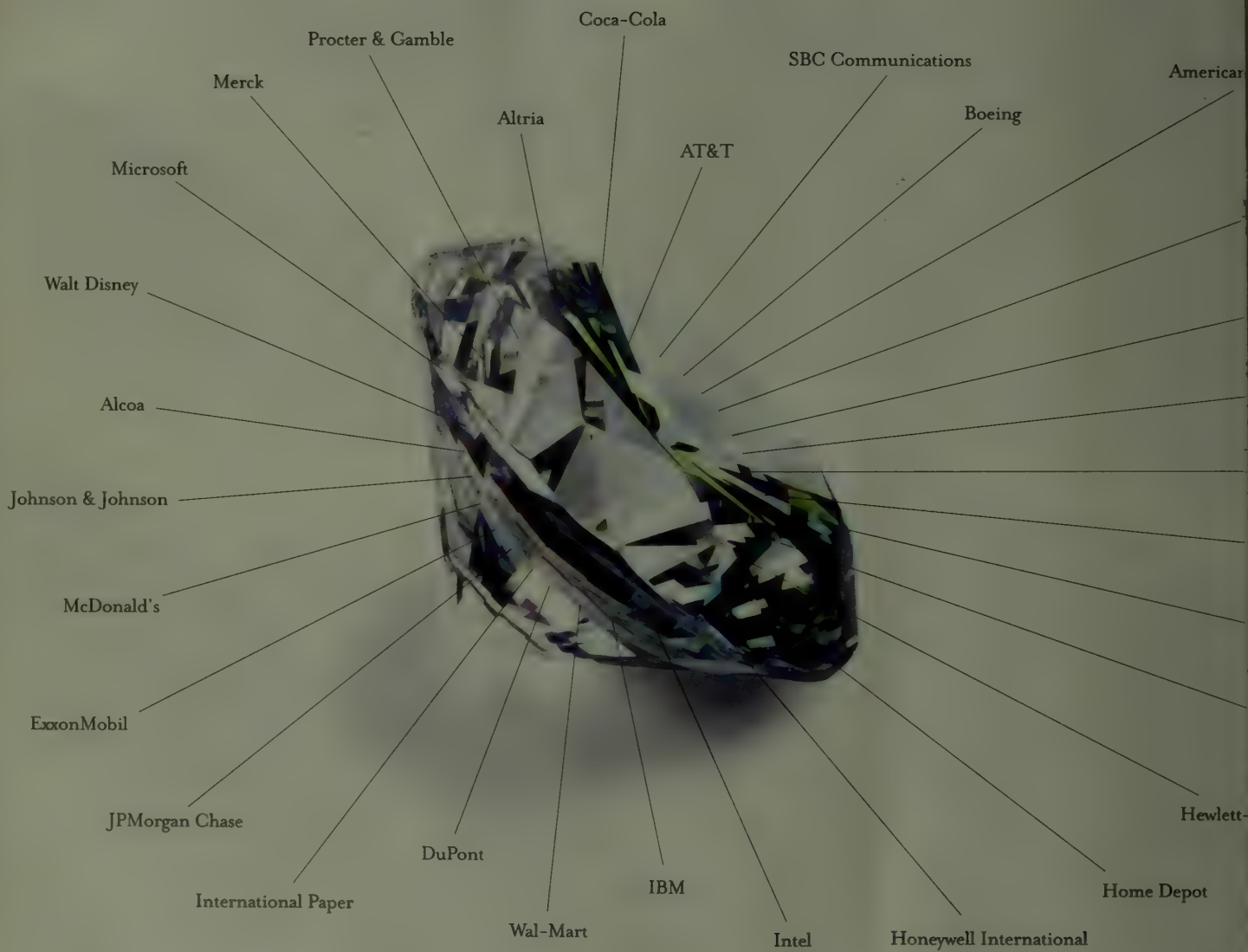
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BY GENE KORETZ

CHINA ISN'T HIJACKING JOBS

Blame multinationals and a savings-short U.S.

The tendency to blame China for U.S. job losses, warns economist Stephen Roach of Morgan Stanley, is more than just misguided. It also raises the specter of a dangerous shift toward protectionism.

With more than 2 million U.S. factory jobs lost in recent years and no sign of a turnaround in hiring, vote-counting politicians have been pointing accusing fingers at China. By doing so, they are reinforcing the view that China's astonishing export-led growth reflects unfair tactics by the country's exporters and their government's refusal to revalue its currency, which has been tied to the dollar since 1994.

On both counts, this view is wrong, says Roach. To be sure, China's exports have tripled in the past decade, and its trade surplus with the U.S. has exploded from \$30 billion to \$103 billion. But the impetus for this export-led growth has come from a surge of foreign direct investment from the developed world.

Fully 65% of the growth in Chinese exports over the past decade, notes Roach, has been generated by subsidiaries or joint ventures of global multinationals. The rising U.S.-Chinese trade deficit, he notes, "is an unmistakable outgrowth of the U.S. penchant for outsourcing and China's rapidly emerging role as a global outsourcing platform of choice." Indeed, companies based in North America, Europe, Japan, and other Asian nations invested \$53 billion in Chinese facilities last year, making it the world's largest recipient of foreign direct investment.

What's more, China's domestic market is far from closed. Its overall trade

surplus is relatively small. And it runs substantial trade deficits with its Asian trading partners (\$31.5 billion with Taiwan in 2002), which ship components and parts to China that are assembled into final export products by its low-wage workers.

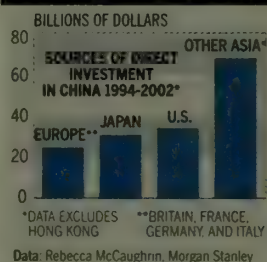
Chinese imports from the U.S. are also taking off. Last year, U.S. sales of aircraft to China soared 42%, to \$3.1 billion, and sales of integrated circuits jumped 38%, to \$1.2 billion.

The bottom line is that China has become an integral part of the global supply chain, and, Roach notes, "the high-cost industrial world needs China for its competitive survival." Roach doubts that an upward revaluation of China's currency by 10% would affect its exports very much.

A truer culprit in U.S. trade woes, he says, is the savings-short U.S. economy. It is an iron law of economics that as long as a nation chooses to invest more than it saves, it must import foreign capital to make up the shortfall—which means running a trade deficit.

With the federal deficit exploding and private saving still anemic, Roach sees an even larger trade gap ahead. "Should China be blamed for Washington's reckless fiscal adventures?" he asks.

WHO FUNDED CHINA'S EXPORT-LED GROWTH



A TAX CREDIT GOES AWRY

Colleges, not students, gain from a tuition break

Back in 1997, Congress passed a program of higher-education tax credits aimed at raising college enrollments. The credits were targeted mainly at middle-class students, who were ineligible for the federal aid available to low-income students.

Thus far, however, the program appears to have been a victim of the law of unintended consequences. In a recent study, Bridget Terry Long of Harvard University finds that the credits—which totaled \$4.9 billion in 2000—did indeed mostly flow to households in the \$35,000-to-\$75,000 middle-income range. But she also finds little evidence that the tax credits boosted overall

college attendance by such students or students in other income groups. All the only discernible effect was a slight pickup in enrollments in four-year institutions relative to two-year colleges.

If anything, the study found that colleges and states that may have reaped gains from Washington's generosity. Since the tax credits offset tuition and fees, many low-cost two-year schools apparently decided to accelerate tuition hikes, as did four-year colleges in states with large financial-aid programs. And that, Long notes, may help explain the muted impact on college attendance.

HATE YOUR JOB? JOIN THE CLUB

The ranks of the discontented are swelling

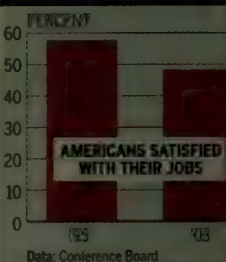
A few years ago, researchers reported that Americans far more confident than Europeans that their work effort will pay off in pay raises and promotions. Unfortunately, those sentiments seem to be waning.

A new Conference Board survey indicates that just 49% of Americans today are satisfied with their jobs—versus 58% in 1995, the first time the survey was done. Only 20% are satisfied with their employer's promotion and bonus policies and just a third with their pay.

Job satisfaction fell most among prime-years workers aged 35 to 54. And it was down sharply among workers in the \$50,000-plus income group—from 67% in 1995.

One source of grievance seems to be the ongoing efforts of employers to squeeze more work out of reduced staffs. Although has resulted in big productivity gains some economists fear that the discontented have fueled could well hurt productivity over the long run.

SINGING THOSE WORKPLACE BLUES



JAMES C. COOPER & KATHLEEN MADIGAN

Corporate America Reaches Its Fighting Weight

Strong, flush, and productive, businesses are ready to answer growing demand

U.S. ECONOMY It has been a tough three years for Corporate America. In the wake of the stock-market bust, businesses everywhere have made painful adjustments to the new realities of the post-bubble economy. More sober assessments of risk and expectations have forced companies to eliminate the excesses in production capacity,

inventories, and payrolls that the boom had generated. Along the way, recession, scandals, and war made the process even more wrenching. The business sector's problems have weighed heavily on the recovery. What's new in the outlook, however, is that companies are now fit and ready to roll. They have restored their financial health, rid themselves of unproductive assets, bloated inventories, boosted productivity and competitiveness, and increased their profitability. Given the strides—and a resurgence in demand—businesses are now willing and able to pull their weight in this recovery. Having Corporate America back in the game ensures a strong and lasting upturn.

IMPROVED FINANCIAL FITNESS is the key to the business sector's turnaround. Amid the talk of supposedly ruinous levels of corporate debt and lingering financial burdens, what has gone largely unnoticed is that corporate balance sheets, in aggregate, have improved significantly over the past year.

The net worth of nonfinancial corporations hit \$9.4 trillion in the second quarter, according to recent Federal Reserve data. Corporate wealth has all but regained its peak level reached at the height of the boom in 2000, and will probably top that mark by the end of the year (chart). Moreover, the rate of balance-sheet improvement in this recovery far outpaces that following the 1990-91 recession. Six quarters into that turnaround, corporate net worth had fallen by \$311 billion. In this upturn, it already stands \$224 billion higher.

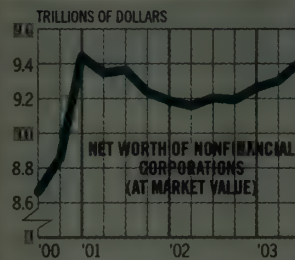
A few debt-laden industries, such as telecom and autos, are laggards in the balance-sheet cleanup. But on the whole, corporate-sector liabilities have increased by only \$385 billion since the recession ended in late 2001. Over the same period, the value of corporate assets has grown by \$609 billion on the strength of big gains in real estate holdings and financial assets.

The performance of financial assets relative to debt speaks volumes about just how financially nimble corporations have become. Since the market bust in 2000, corporate debt, including bank loans, bonds, and other credit-market obligations, has increased by \$520 billion, but financial assets have jumped by \$1.5 trillion.

Clearly, companies have great ability to meet their obligations, and debt will not be an obstacle to corporate expansion as the economy picks up speed. Indeed, corporate borrowing is beginning to pick up again as businesses take advantage of rapidly improving borrowing conditions in the credit markets and at banks.

Not that cash-rich outfits really need to borrow. The cash flow of nonfinancial corporations peaked in 1997 and bottomed out in 2001. Since then, more generous depreciation allowances within the tax code and the ongoing profits recovery enabled cash flow to grow by \$180 billion, to \$781.3 billion in the second quarter. That was enough to cover 99% of all capital expenditures and

CORPORATE WEALTH IS RISING AGAIN



Data: Federal Reserve Board, Global Insight Inc.

inventory investment by nonfinancial businesses.

The surge in corporate cash partly reflects the payroll savings from layoffs. But it is also the result of the dramatic shrinkage in the cost structure of Corporate America over the past three years. For instance, lower interest rates and a slowdown in new borrowing have greatly cut the cost of servicing existing corporate debt. Net interest costs for nonfinancial businesses have declined as a percentage of both corporate output and cash flow.

Also, productivity gains have cut unit labor costs and boosted profit margins, even at a time of weak pricing power. And margins have benefited from the elimination of excess capacity, which has lowered fixed costs. Now, with sales accelerating, more revenue is going straight to the bottom line. An even stronger second leg of the profits recovery is shaping up for the second half of 2003.

IT'S IMPORTANT TO NOTE that the asset-led gains in corporate net worth have come even as companies have slashed their extra production capacity, which counts as a tangible asset. Since the recession ended, the value of equipment and software held on corporate books, based

on replacement cost, has declined slightly, something that never happened previously in the post-World War II era (chart).

Another way of looking at the capacity adjustment is to compare new capital spending with the rapid rate at which equipment and buildings are wearing out. Through the first half of 2003, the ratio of new outlays to depreciation was running at the lowest level for any year in the postwar period. This suggests that, after one of the biggest capital spending busts since the Great Depression, pent-up demand for new equipment and software may now be building—especially demand for tech gear, where the replacement cycle is long overdue.

Capacity levels in manufacturing, for example, which had been growing 8% annually in the late 1990s, are now growing only 1% per year. Capacity growth among tech-equipment producers has plunged, from 50% to just under 9%. In fact, so far this year, tech-capacity growth is actually speeding up for the first time in three years, signaling that the tech sector has essentially completed its post-bubble capacity adjustments. That may not be true for telecom, but makers of tech equipment generally appear to be in the early stages of expanding their capacity in response to stronger demand.

GIVEN THAT PICKUP IN DEMAND and the fading of financial stress, businesses are not only ready to pump up their spending on new equipment but also set to restock their warehouses. That will provide yet another kick to economic growth. In particular, inventories of tech

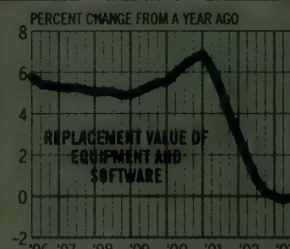
equipment, which had ballooned after the bubble burst, are once again aligned with sales.

Elsewhere, though, inventories are far too skimpy, given the faster pace of demand. Since the end of last year, economywide inventories have shrunk at an annual rate of 0.6%, while overall demand for goods has grown

at a 4.6% rate. In the third quarter, that disparity widened further as demand accelerated

As a result, economists at J.P. Morgan Securities Inc. conservatively project that inventory rebuilding will boost economic growth by an annual rate of about 0.5 percentage point in coming quarters, even when one accounts for

WHERE CORPORATE ASSETS HAVE SHRUNK



Data: Federal Reserve Board, Global Insight Inc.

the market share taken by imports. The lift might even be greater if businesses expand their inventories as fast as sales are now growing.

Given businesses' healthier financial condition, paying for those additional stockpiles will not be a problem. More important, stronger corporate balance sheets mean companies are also ready to add additional workers to meet rising demand. For the first time in three years, Corporate America and Household America are starting to pull together. ■

GERMANY

Half-Hearted, But a Rebound Nonetheless

GERMANY'S RECOVERY from recession will be slow and uneven, casting doubts on structural reforms and solutions to the rising budget deficit.

The economy has not grown for three quarters in a row, but now the outlook is more hopeful. Industrial production rose 2.5% from June to July. Vehicle assemblies were strong as auto makers recouped production lost during a strike in June. Consumer and business confidence are rising, and the stock market is up 60% since hitting a 7-year low in March.

Chancellor Gerhard Schröder is counting on tax cuts of 22 billion euros (\$24 billion) to lift demand in 2004. In addition, companies have cut

their debt levels and are seeing profits rise. Those moves will generate more money for capital goods. But a recent Bundesbank report says the construction sector shows no improvement yet. And the gain in auto output, a key sector in Germany, will be short-lived. Vehicle sales are down from a year ago, and Germans now hold onto their cars for an average of one year longer than they used to.

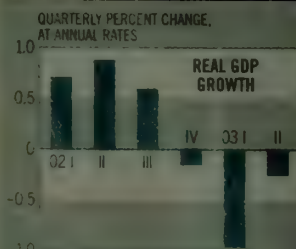
Better growth abroad will certainly help, but exports won't lead this upturn. The euro's recent volatility, triggered by remarks from the Group of Seven on flexible exchange rates, shows that Germany cannot depend on a weaker currency to stimulate foreign sales.

Even if exports pick up modestly, the consensus is that the economy will grow at an annual rate of just under 1% in the second half of 2003 and then less than 2% in 2004. Unfortunately, the economy needs to expand faster than that to significantly lower unemployment now running at 10.6%—or to generate enough corporate tax receipts to lower the budget deficit. Moreover, the strong showing by the opposition in the Sept. 21 Bavarian elections indicates that Schröder will face a tough time in getting through any pension and labor reforms.

The German budget deficit in 2003 will run above 3% of the economy the third year in a row. That will again put Germany in violation of the Stability & Growth Pact. But for now Schröder seems more focused on jump-starting the economy than pursuing fiscal discipline. ■

—with David Fairlamb in Frankfurt

FOR GERMANY, THE WORST IS OVER



Data: Global Insight Inc.



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WALL STREET

NEW BROOM AT THE BIG BOARD

Enter John Reed. Can the former Citi boss bring real change to the troubled New York Stock Exchange

EVEN HIS MOST LOYAL defenders acknowledge this: When a disgraced Richard A. Grasso left the New York Stock Exchange on Sept. 17 in the wake of the furor over his \$188 million pay package, he left behind a world-class mess. The NYSE's image was in tatters, institutional investors demanded ouster of the board, and floor traders feared changes were afoot that would destroy their franchise. So on Sept. 21, when the NYSE board named former Citi boss John S. Reed as interim chairman and CEO, the relief was almost palpable.

But nobody is breathing easy just yet. Not the still-jittery floor community. Not investors. Not the NYSE's much-ridiculed board of directors. And, above all, not

Reed. The Securities & Exchange Commission is counting on the 64-year-old retired banker to start the beleaguered exchange on the road toward what could be a dramatic transformation. Although he lacks hands-on experience in the securities industry and will likely face powerful pressure for inertia, Reed is no stranger to corporate transformation. Says James Dimon, CEO of Bank One Corp. and a former Citi colleague: "He understands technology. He understands global capital markets, the global role for the New York Stock Exchange. He clearly is respected on issues like corporate governance."

Friends and associates describe a cerebral, worldly—as well as somewhat distant and cold—intellectual who is the polar opposite of the emotional, narrowly focused college dropout Grasso. After a

banking career in which he presided over a technological revolution in retail banking, the Chicago-born Reed left Citigroup in 2000 after losing a bruising power struggle with co-CEO Sanford I. Weill. Friends say he is probably relishing a second chance to end his career on a high note. Says his friend Yacine Aït-Sahalia, director of Princeton University's Bernheim Center for Finance, where Reed lectured in 2002: "It was almost a quest of duty—a call to duty. He's not the kind of guy to escape a draft."

PRESSURE, PRESSURE

REED'S FIRST CHALLENGE, when he starts work on Sept. 30, will be to make major changes in the exchange's widely discredited corporate governance. He is being pressed to wield an ax against

IN THIS SECTION:

8 | Energy's loss is the economy's gain

51 | The Kozlowski trial: A front-row seat

54 | What to do with all those obsolete PCs?

56 | Winston-Salem's economy gets burned



WHAT A MESS Even Grasso's defenders acknowledge he left behind a fiasco

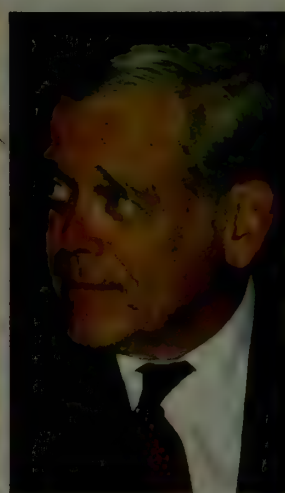
some of the most conflicted or weak NYSE board members. A top SEC official asserts that "a lot of people whose judgment is questionable are making major decisions, and that's a worry"—and named NYSE Director H. Carl McCall, a former New York state comptroller who heads the compensation committee and the governance review committee. McCall did not return calls seeking comment.

Clearly, the status quo is no longer an option—not with pressure from all sides. On Sept. 24, seven state treasurers gave the NYSE board a laundry list of proposals, including a complete overhaul of the board. They also want the SEC to appoint an independent panel to probe NYSE operations and governance. New York Attorney General Eliot Spitzer (page 129) says approval of the Grasso pay package represented a "breakdown in board behavior." That day, Reed told Bloomberg News Service that he would cut the board to 10 or 12 members, down from its current 27, and that he will stay on the job for only about three months.

WHO'S NEXT?

THE SEC IS WATCHING with intense interest. A top official says the agency staff and Chairman William H. Donaldson have little enthusiasm for one proposal—the creation of a nonexecutive chairman, instead of the current combined CEO-chairman setup. But the agency might favor an arrangement that would allow the NYSE and other markets to keep their own surveillance units, while shifting enforcement to a single regulatory body. A host of NYSE constituencies, from investors to floor brokers, are also calling for increased disclosure.

A saving grace, from Reed's perspective, is that floor traders—a notoriously conservative lot—now recognize that



MISSION: REFORM The appointment of Reed (left) won praise from all quarters, including the SEC's Donaldson. Sources say Reed is likely to appoint his own search committee for a permanent CEO

governance changes, and even beefed-up regulation, are inevitable. This is part disgust at Grasso-era excesses, part "if you can't beat 'em, join 'em" pragmatism. "Corporate governance needs to be addressed immediately," says one influential Wall Street CEO whose firm wields power at the NYSE. "Reed has to stabilize the situation, get people on the road to reform, and get credibility back."

Probably the biggest short-term issue is succession. Although various names of permanent CEOs have been bandied about—notably Peter R. Fisher, a Treasury Under Secretary who was considered for interim chairman—sources familiar with the board's deliberations that the decision is up to Reed and that he is likely to set up his own search committee.

Just as vital is the NYSE's review of its corporate governance practices, originally due to the SEC on Oct. 2. With the current board rapidly losing its remaining

clout, that date has been delayed to give Reed a chance to put his stamp on it. "What existing group has done should be considered just one input," says a top SEC official. "Even if they are capable of coming up with the right answers, Reed has to validate it by taking the board through a process that produces designs."

THE NEW GUY

STRAIGHTENING OUT the corporate governance debacle is a thorny enough—but it's a challenge compared with the NYSE's long-term issues. There is, for example, the fate of the trading floor—long defended by the exchange as the best way to set prices but lambasted by critics as an outmoded system

that hurts investors. Regulations that protect the NYSE franchise are now in danger. The Exchange will probably be forced to accept some kind of change in its previously sacrosanct "trade-through" rule, which prohibits orders from being executed off the floor if a better price is available on the floor. That hurts NYSE competitors that provide faster execution, which institutional investors often prefer over best prices.

In confronting such long-festering issues—and a potentially troublesome SEC investigation of the trading floor—may help that Reed is new to the Street. He has no vested interests to protect. Herbert M. Allison Jr., an NYSE board member who is chairman and CEO of TIAA-CREF, notes that Reed "has had close relations with the exchange and he has moral courage." His detached, intellectual approach is also a plus. His friend Michael Doyle, a Columbia University profes-

sor, notes that Reed is "deeply appreciative of science and rigorous methods. He is fascinated by tough questions. That's good news. Tough questions abound at the NYSE. But tough answers are about as hard to find as a once-plentiful commodity: defender Dick Grasso. ■

—By Gary Weiss
New York and Paul
Dwyer and Amy Boyer
in Washington
with bureau rep

John Reed's Agenda and...

RESTORE public confidence in the exchange

REFORM the Big Board's governance, such as by splitting off regulation from operations and boosting transparency

SELECT a revamped board of directors and CEO who can live with the changes

MINIMIZE the damage caused by an SEC investigation of floor trading practices

CALM a nervous trading floor and jittery exchange staff

...What His Successor Must Do

DECIDE whether a longtime plan to turn the NYSE into a public company should be dusted off

ADDRESS widespread concerns about the viability of the floor-trading system

FEND OFF encroaching competitors, which are likely to multiply because of regulatory changes under discussion

BALANCE the competing interests of floor traders and institutions, who complain of bad trade executions

COMMENTARY

MICHAEL J. MANDEL

Reform the Exchange—Gingerly

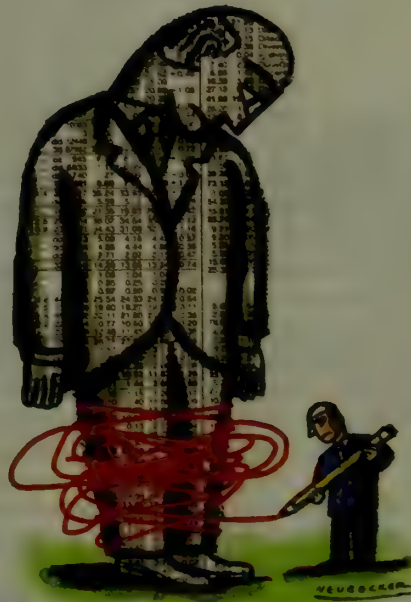
Too many changes could damage the NYSE, and with it the U.S. economy

OVER THE LAST decade, the U.S. financial markets—and the New York Stock Exchange in particular—have been one of the few U.S. sectors to gain market share globally. While formerly dominant industries such as commercial and heavy manufacturing have lost ground, the NYSE still reigns supreme, with far more liquidity than any other trading venue or exchange. In the first half of the 1990s, the NYSE accounted for 28% of the value of all shares traded globally. By 2002, that had risen to almost 31%. Even after two years of Wall Street scandals, the strength of the U.S. financial markets—their attractiveness to traders, their ability to withstand shocks, their success in financing both existing corporations and new businesses—is a key competitive advantage of the economy.

That's why, in the aftermath of Richard Grasso's designation as Big Board chairman, it's essential that NYSE reformers tread carefully. There is plenty of pressure to make changes in the exchange. Nevertheless, the history of regulation shows that bad consequences often can arise from good intentions. In particular, anything that hurts the ability of the NYSE and the financial markets to compete could hurt the U.S. economy as well.

True, the NYSE needs to make changes. The reforms, however, should focus on improving the transparency of the exchange's operations and governance rather than imposing new rules. More openness would have made it harder for Grasso to get such an outsize pay package. Better governance—

including creating a board with a majority of independent members—would bolster the faith of both institutional and retail investors and better protect their interests. The problem is, the reformers may not stop there. There are signs that the Securities & Exchange Commission will want the NYSE to shift its resources to better monitor the markets to prevent abuses such as insider trading and front running, in which floor traders profit from advance knowledge of the trades. That would force the exchange to focus less on doing business and more on enforcement. Moreover, later in the fall the



SEC may consider a major modification of what's known as the trade-through rule, which today requires orders to flow to the NYSE if its specialists are quoting the best price. Changing the trade-through rule—a proposal that the SEC has been working on for six months—would benefit institutional traders, who now complain that they often don't get the quoted price from the specialists. Instead of trading on the NYSE, they want to divert

much of their business to electronic trading systems that offer faster trades at prices nearly as good.

Despite the genuine appeal of these reforms, either could well backfire. Increasing the intensity of regulation and reducing spending on business development could significantly reduce the NYSE's competitiveness, especially since the focus on attracting new listings has helped the exchange maintain its global primacy. Equally important, the trade-through rule helps ensure a high volume of trades—and liquidity—for the NYSE. That's a real plus. Allowing institutional investors to spread their trades out among different exchanges may be preferable in most circumstances, but it might make it harder to maintain liquidity in periods of financial stress.

The NYSE, for all of its foibles and flaws, has successfully served as the bulwark of the financial system through boom and bust. That means major reforms should be made carefully. In particular, the fact that institutional investors would prefer to trade off the exchange is not conclusive evidence that it would lead to a better financial system.

The stock exchange clearly made a mistake by paying Grasso so much money. But if the response is too draconian, the rest of the economy will suffer for the sins of a few. ■

THE NYSE STILL RULES



Data: World Federation of Exchanges

ENERGY

A FRAGILE REPRIEVE ON ENERGY

Easing gasoline, crude, and natural gas prices could rev the recovery—if they last

AS RECENTLY AS AUGUST, high energy prices looked as if they might become a serious obstacle to economic recovery in the U.S. and abroad. Oil was more than \$30 a barrel, natural gas remained in short supply, and gasoline had hit an all-time high. Federal Reserve Chairman Alan Greenspan captured the concern in congressional testimony in July, when he warned of “debilitating spikes” in the price of natural gas. The big worry: If energy prices were high when the economy was slack, how much higher would they go when it was firing on all cylinders?

Then a funny thing happened: Growth began to accelerate, but rising inventories allowed energy prices to drop rather than rise. From late August through Sept. 23, crude oil fell 14%, to about \$27 a barrel, and natural gas dropped 15%, to \$4.50, in futures trading on the New York Mercantile Exchange. Even stubbornly expensive gasoline began to fall: The average retail price for self-serve regular unleaded has fallen for four weeks in a row, dropping a dime from its peak, to \$1.64 on Sept. 22.

Energy consumers may have rejoiced, but producers certainly didn't: Increasingly

worried about the slide in crude prices, OPEC oil ministers meeting in Geneva on Sept. 23 agreed to cut production by 3.5%, rolling back a June 1 hike. The move surprised the markets—which had expected OPEC to hold production steady—and sent crude prices back up \$1.11, to \$28.24, in Nymex trading by the end of the day. Analysts quickly concluded that the cartel isn't trying to force prices up, but it does want to stem any further slide. “They are showing they're ready to defend the price,” says George Beranek, manager for market analysis at consultant PFC Energy in Washington.

SKITTISH STOCK MARKET

HITTING THAT BALANCE JUST right is a tricky business given the intensely volatile energy markets. A major disruption—say, a cutoff of Iraqi production or a harsher-than-expected winter—would send prices back up. And if current cuts don't work, there are likely to be more. Beranek thinks OPEC could announce further cuts of 1 million to 2 million barrels a day when it meets in December.

OPEC's move also roiled stock markets, sending the Standard & Poor's 500-stock index down 1.9% as investors worried that a jump in oil prices could boost costs

VOLATILE
OPEC moved to cut output, but that may not push prices up sharply

and cut into the nascent earnings revival. Some see the fear as overblown. Bruce Stearns & Co. oil analyst Frederick P. Leffer says OPEC's cut di-

change his prediction that prices will average \$18 a barrel next year, vs. \$30 a year. Says Leffer: “So far this quarter every OPEC member except Venezuela and Indonesia have cheated on quota.”

The moderation in energy prices, sustained, will help the economy by boosting consumer spending, helping keep the expansion alive as business investment starts to kick in. David A. Wallis, chief economist at Standard & Poor's, says the price drop will lower inflation about a quarter of a percentage point

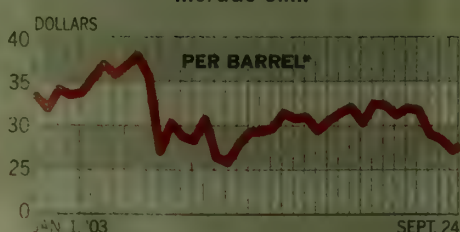
ENERGY: THE PRESSURE IS LIFTING

Prices have fallen for natural gas...



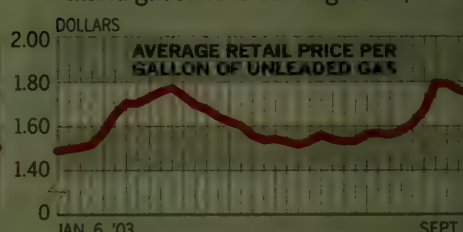
Data: Bloomberg Financial Markets

...crude oil...



Data: Bloomberg Financial Markets

...and gasoline is coming down, too



Data: Energy Information Administration



economic growth by a tenth of a percentage point or so. And cheaper energy helped revive consumer confidence, says Bruce C. Kasman, head of economic research for J.P. Morgan Chase & Co. Economic growth stays strong into fourth quarter, will energy prices rebound? It's possible. But there's reason to believe that won't happen. For one thing, stronger growth doesn't trigger as much increased energy consumption as it once did because of improved efficiency. In the U.S., output per unit of energy, adjusted for inflation, is up 77% since 1973, the year of the first Arab oil embargo. For another, global growth isn't exactly torrid.

PLENISHED RESERVES

MORE IMPORTANT, supplies are growing along with demand. Fighting sabotage, Iraq has managed to raise its oil output to 1.3 million barrels a day—about half the 2.5 million barrels it produced daily before the U.S. invasion. Venezuela, too, has bounced back after a crippling strike: It's producing about 2.6 million barrels a day, vs. 3 million pre-1995. Russian oil production this year, however, will average 8.2 million barrels a day, up 7% from last year.

The outlook for natural gas has brightened as well. The Nymex price spiked to \$8 in late February on shortages caused by severe weather. As recently as July, the price was above \$6 per million

BTUs on fears that producers couldn't rebuild depleted reserves in time for winter. But the summer was mild in much of the nation, dampening demand for natural gas from electric utilities to run air conditioners. High prices also scared off some customers. So buyers were able to rebuild inventories to almost normal levels.

FLEXIBILITY

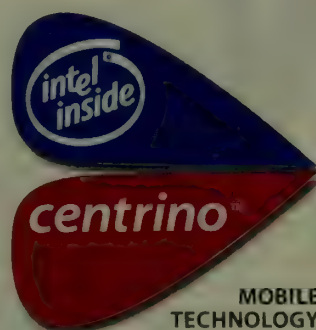
EVEN GASOLINE IS FINALLY coming down. For much of the spring and summer, prices rose far more than the runup in crude oil could explain, hitting a national average of nearly \$1.75 a gallon just before Labor Day—the highest ever before inflation. Because refiners underestimated demand, they cut back on production. Then, when summer driving came in above expectations, prices shot up, allowing refiners' profit margins to triple or more. Gradually, though, competition among refiners and retailers is raising supply and forcing margins back down. Tom A. Kloza, chief oil analyst at OPIS Energy Group in Lakewood, N.J., thinks gas will fall 15¢ to 30¢ by Thanksgiving.

Energy markets are volatile, but in the long run, there's plenty of flexibility to tame prices. High prices spark more supply, sending prices down. That has been the case lately for oil. Western and other non-OPEC oil producers, including Russia, are stepping up exploration. When demand spikes, imports flood in.

The natural gas market is more vulnerable because it lacks the safety valve of imports. Just 1% of natural gas used in the U.S. comes from outside North America. Only four ship terminals capable of handling imports of supercooled liquid natural gas exist in the U.S., and they're at full capacity. That's one reason Mark G. Papa, chairman and CEO of Houston oil-and-gas producer EOG Resources Inc., warns that "we're not out of the woods yet" on natural gas supply.

That said, the betting is that energy prices will fall in the coming year. One help: The Energy Dept. is forecasting a normal winter, in contrast to the frigid one of 2002-03. On the Nymex on Sept. 24, natural gas for January delivery was \$5.21—not too far above the \$4.59 of the October contract. Crude was \$27.60, down from \$28.24 now. And January wholesale unleaded gasoline goes for 75¢, vs. 87¢ today. For now, the markets remain convinced that energy prices will help, rather than hinder, the recovery. ■

—By Peter Coy in New York, with
Stephanie Anderson Forest in
Dallas, Stanley Reed in London, and
Christopher Palmeri in Los Angeles



Carry on.

AUTO MAKERS

REINVENTING THE HYBRID WHEEL

Will Toyota and others convince buyers that the latest models are more than weird science?

WHEN TOYOTA launched the 48-mile-per-gallon Prius gasoline-electric hybrid sedan three years ago, the compact-size novelty

hit a chord with enviros and technology buffs. But it never did much for Evan Fusco. Now, Fusco, a 36-year-old emergency-room doctor from Nixa, Mo., is happily plunking down \$21,000 for a second-generation Prius, plus \$5,000 more for such extras as an onboard navigational system. While he's glad his new wheels get 55 mpg, he's more excited about the car's roominess, sleek lines, and high-tech feel. Says Fusco: "I'm not a radical greenie."

It looks like there are plenty more Fuscus out there. When Toyota Motor Corp. launched the car in Japan in September, it sold 11,000 Priuses in the first two weeks, beating expectations eight times over. In the U.S., dealers are scrambling to keep up with orders. Already, Toyota says 10,000 orders have come in. In San Francisco alone, one local dealer has cash deposits down for 100 Priuses, or two months' worth of inventory. All of which suggests that Toyota may well meet

its goal of selling 35,000 in the first year.

Are hybrids going mainstream? Not yet. But Toyota is pushing hard to exploit its early lead in hybrid technology, even as it drives down the production costs. After the Prius, Toyota plans a slew of new hybrid models, which should hit the market beginning next year. They include the auto giant's Lexus luxury brand, which is racing Ford Motor Co. to bring the first SUV hybrid to market. And even though Detroit is readying its own fuel-efficient models and Honda is adding the Accord to its two-car hybrid lineup, rivals concede that Toyota has the edge. Says one Honda executive: "If Toyota can drive the cost of the technology down, they will have a 5-to-10-year lead on every other manufacturer."

DON'T PLUG THEM IN

BUT FIRST, TOYOTA and the rest of the industry must convince buyers that hybrids aren't just weird science. Toyota's marketing will lean heavily on Prius' size and power in addition to its eco-friendly

reputation, says Meyer. The auto m is pushing the new crop as full-performance, full-size vehicles that also happen to get boffo gas mileage. P ads will hit TV networks in November drive home the point. The first spots remind consumers that the Prius doesn't need to be plugged in, since it recharges its battery using the brakes. Even the hybrids have been on the market three years, 50% of consumers don't know that, Meyer says.

The real plug for hybrids comes next year, when Lexus and Ford offer hybrid technology to soup their SUVs. Toyota's Lexus 330 hybrid sport-ute, which goes on sale next summer, will mate a V-6 engine with electric motor to get the horsepower of a brawny V-8 engine at 30 to 40 mpg. Lexus will charge as much as \$5,000 more for the hybrid RX 330, the SUV will outrun the regular V-6-powered RX 330. Toyota also plans to sell hybrid versions of its Highlander SUV, Sienna minivan in a few years. Ford enters the fray with a gasoline-electric version of the Escape SUV. Says Ford Chairman and CEO William C. Ford: "We're not asking the customer to give up passenger space, luggage space or acceleration."

Sounds great. Now if only the hybrids can actually make money. The original models, launched by Toyota and Honda Motor Co. three years ago, lost as much as \$8,000 a car. And the first-generation Prius, about the size and price of a Toyota Corolla, cost \$6,000 more than that compact. The new Prius is the same size and price as a midsize Camry. The Prius is

profitable yet, but Toyota predicts that if sales continue at the current pace, the hybrid will cover its development costs and move the black in a few years. The race to dominate the hybrid market, there's denying that Toyota is out in front. ■

—By David Welch, Kathleen Kerin in De



THRIFTY
Toyota Prius

Here Come The Hybrids

TOYOTA PRIUS

The second-generation Prius gets a bit greener with a 7 mpg boost to 55 mpg. It costs about as much as a Toyota Camry. Price: \$20,000.

CHEVROLET SILVERADO

The pickup goes on sale in early '04. Has juice, but packs only a 12% mileage boost to 20 mpg. Price: from \$31,000.

LEXUS RX

Arriving in summer, 2004, it guzzles less gas than the popular RX 330 luxury SUV. Still has V-8 power, but gets nearly 35 mpg. Not yet priced.

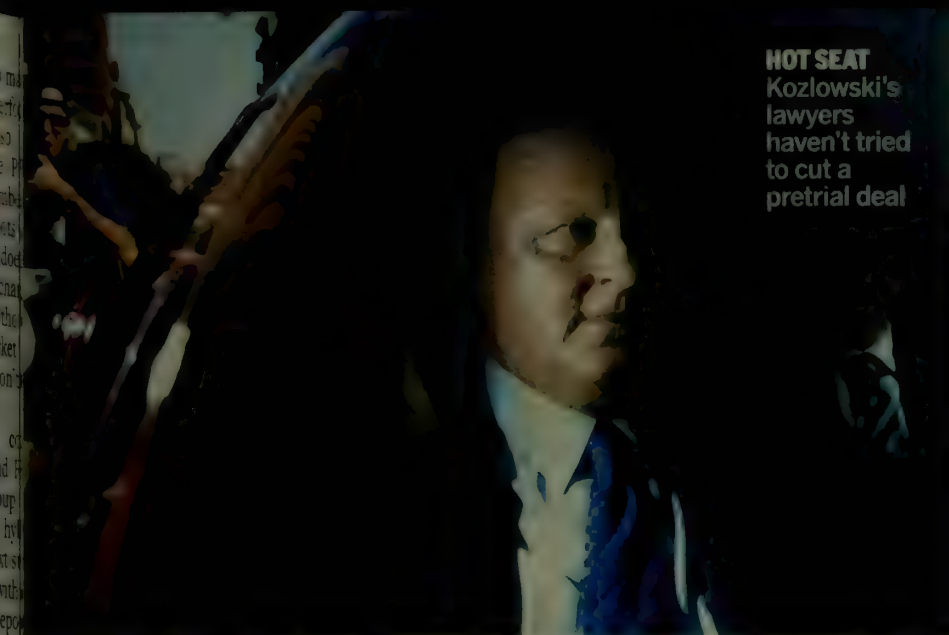
FORD ESCAPE

Racing against the RX to become the first gas-electric SUV on the road. It promises to get up to 40 mpg. Price: about \$26,000.

SATURN VUE

In late 2005, Saturn will weigh in with its hybrid SUV, the 200-horsepower 40 mpg Vue. Not yet priced.

Data: Company reports



HOT SEAT
Kozlowski's
lawyers
haven't tried
to cut a
pretrial deal

CORPORATE CRIME

TIME TO FACE THE JURY, MR. KOZLOWSKI

He's staring at a raft of serious charges, but it's the DA's office that must clear some high hurdles

ON SEPT. 29, FORMER Tyco International Ltd. chief L. Dennis Kozlowski stands trial in downtown Manhattan. His trial will kick off a string of upcoming cases against executives in the next few months. The trial of Credit Suisse First Boston investment banker Frank Quattrone starts the same day, and WorldCom CFO Scott Ivan and Martha Stewart look set to face their day in court early next year.

Kozlowski hasn't cut a deal to settle the charges, unlike recent cases against other corporate top dogs, including Sotheby's chairman CEO Diana D. Brooks and former Rite Aid CEO Martin Grass.

The case against Kozlowski, the now-imprisoned former CEO ofClone Systems Inc., was delayed long before it reached jury selection. Given that Kozlowski's lawyer, Stephen Kaufman, is well known for striking pretrial deals on behalf of famous clients like Brooks, the odds of a trial have sur-

prised observers and may in part reflect how hard it will be to prove the charges.

Prosecutors from Manhattan District Attorney Robert M. Morgenthau's office allege that Kozlowski and his former CFO, Mark H. Swartz, created a criminal enterprise that they used over seven years to steal \$170 million from Tyco in unauthorized loans and bonuses and to defraud investors of an additional \$430 million. Like Kozlowski, Swartz has pleaded not guilty to all charges. Here's a look at the trial to come:

How will the prosecution build its case?

Morgenthau has put five top lawyers on the case, including the pair who convicted mother-and-son grifter team Sante and Kenneth Kimes of murder, despite having had no body. (That conviction is on appeal.) The DA's office is expected to put hundreds of documents into evidence and call a variety of former Tyco employees and board members to the stand. Included on the roster could

The former Tyco chief is not expected to take the stand in his defense



**(And on, and on,
and on, and on...)**



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be the company's former outside auditor, Richard Scalzo of PricewaterhouseCoopers. He recently settled Securities & Exchange Commission charges of negligence at Tyco without admitting wrongdoing and agreed not to audit public companies. Prosecutors are also likely to call on former board members and Tyco staffers in an attempt to prove that Kozlowski was a financially savvy executive who flouted board limits on compensation and entered into secret financial deals with executives and directors. That will take months, raising another challenge for the prosecution: keeping the jury's attention.

What will Kozlowski's defense be?

He'll depend heavily on the argument that auditors and the board approved what was going on. Lawyers for Kozlowski and Swartz declined to comment on their case, but in pretrial motions they won the right to introduce evidence that Tyco's outside auditors were given full access to Tyco personnel and financials. In pretrial hearings, Kozlowski lawyer Austin V. Campriello argued that a key to Kozlowski's defense will be showing he did not hide his actions. Why? Proving larceny charges requires convincing a jury that he intentionally stole from the company, then tried to hide it.

Will Kozlowski take the stand?

Former prosecutors and criminal lawyers say probably not, for fear of opening himself up to damaging questions about his lavish lifestyle. A trip to the stand, for instance, could find Kozlowski answering questions about the now infamous Sardinian birthday party he threw for his wife, Karen, in 2001; prosecutors allege the company picked up much of the \$2 million tab. "It's usually a last resort only if the case goes really badly for him," says Robert Seiden, a prosecutor in Morgenthau's office for 11 years and president of Fortress Global Investigations Corp.

How serious are the charges?

Enterprise corruption, one of 37 charges Kozlowski and Swartz face, is a class of crime comparable to manslaughter in the first degree. The penalty: up to 30 years in New York State jail for that alone.

But if Kozlowski is worried, it doesn't show. At a pre-trial hearing on Sept. 23, he looked relaxed and trim in a well-tailored suit. Swartz, too, was tanned and smiling. The question is how they'll look after a winter spent in court. ■

—By Nanette Byrnes in New York

COMMENTARY

BY ROGER O. CROCKETT

Motorola Needs A Revolutionary

The new CEO will have to slash and innovate—fast

INVESTORS CHEERED when Christopher B. Galvin resigned as chairman and CEO of Motorola Inc. on Sept. 19. Despite making some progress on the company's slow-mo turnaround, Galvin couldn't overcome a brutal economy or a board that didn't share his vision. The day after he resigned, the stock jumped 9%. "Hallelujah," says Barbara L. Rishel, senior portfolio manager for MTB Investment Advisors Inc., which owns Motorola shares.

Don't break out the bubbly just yet, though. Motorola needs to find a new chief—ideally an outsider—with the technological savvy and operational acumen to turn the company around. And the sooner the better. Rivals are moving the goalposts even as Motorola tries to right itself. *BusinessWeek* has learned that Nokia Corp. was expected to announce a reorganization on Sept. 26. The goal: to create a handful of market-focused units able to accelerate its move beyond cell phones into consumer electronics.

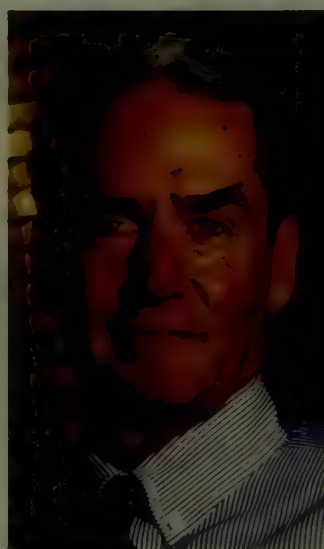
To meet that and other challenges, the CEO will have to shake up Motorola's struggling businesses. Its wireless infrastructure and semiconductor units are weak, and the design and production systems need to be further overhauled to get new products out faster. Says Michael Birck, CEO of Tellabs Inc.: "Someone needs to grab hold of this thing and make it happen."

Motorola says it is

looking inside and outside the company for a new chief. On Sept. 2, Chief Operating Officer Mike S. Zafirovski expressed interest in the job, according to Reuters. But investors and some insiders question whether he has proven himself. Mike Z, as he is known, is an aggressive leader who pushed the cell-phone unit into the black after joining the company in 2000. But since

he moved up to COO a year ago, Motorola's chip performance has lagged the industry, and cell-phone margins have fallen from 7% to 3% like Mike," says one shareholder, "but I do know if he's ready."

Motorola would do better to bring in an outsider. It needs someone immediately capable of cutting through the company's notoriously intractable bureaucracy and hidebound engineering culture. Motorola is famous for hanging on to technologies such as analog and satellite phones long after the



GALVIN The day after he resigned, Motorola's stock jumped 9%



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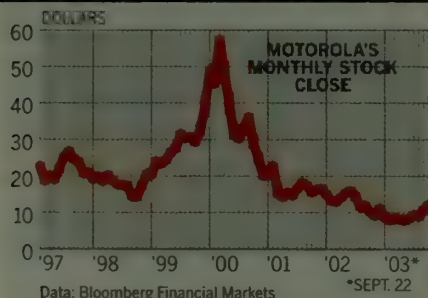
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market rejects them. Motorola needs a leader like Edward D. Breen Jr., the former COO it lost to Tyco International Ltd. in 2002 after just a few months on the job. Breen impressed many by killing unpromising cable-modem technology and urging the sale of the wireless-infrastructure unit. "My issue with Motorola has always been the glacial pace of how they run their businesses," says Kevin M. Rendino, a fund manager at Merrill Lynch & Co., which owns 9.7 million Motorola shares.

The company also needs a leader with a proven record for divining key tech trends. With wireless growth slowing and phones fast becoming a commodity business, Motorola's next chief needs to understand how to catapult into such promising areas as gaming and PC-like smart phones.

That's where a Silicon Valley exec could help—someone who knows how to develop technology that matches what customers want. That has been a perennial problem at Motorola, which has failed to customize cell phones for key carriers such as Sprint Corp. The

THE GALVIN EFFECT



new CEO ideally would have experience in both marketing and technology—one reason investors say Edward J. Zander, former CEO of Sun Microsystems Inc., would be a good fit.

Above all, the next chief will need to be tough. He or she will have to decide what to outsource and what to keep in-house, as well as what to jettison. While its walkie-talkie technology is a keeper, axing the rest of the infrastructure biz looks like a no-brainer. Figuring out what to do with semiconductors won't be so easy, since wireless chips are part of the company's heritage. That's precisely why an outsider would be best: Motorola needs someone willing to slay a few sacred cows. The company's success may depend on it. ■

—With Andy Reinhardt in Paris

THE ENVIRONMENT

THE INFORMATION AGE'S TOXIC GARBAGE

California could set the standard for dealing with discarded PCs

IT'S ENOUGH TO MAKE ANY environmentalist cringe: In 2003 alone, an estimated 63 million desktop personal computers in America will become primed for the scrap heap. Each contains roughly four pounds of lead—most of it in the monitor—not to mention small quantities of highly toxic cadmium and mercury. That adds up to a lot of nasty garbage, much of which is now dumped in landfills or shipped to nations with lax environmental laws. Says David Wood, the executive director of Grassroots Recycling Network: "It's time to address the electronics-waste issue before it gets any worse."

California, the bellwether state of green policymaking, is doing just that. On Sept. 12, the California Senate passed a bill that would impose a recycling fee of \$6-\$10 on every PC sold in the state. The money would finance a government program to dispose safely of the toxic metals found in monitors and circuit boards. PC makers also would be forced to phase out dangerous materials. If Governor Gray Davis signs the bill—which he was expected to do on Sept. 25—it could create a model for greens in other states to emulate. This comes just as Corporate America is poised to start replacing millions of its aging PCs and monitors with new gear.

The great e-waste debate really erupted two years ago, when it was revealed that many of the nation's discarded personal computers were being shipped to poor nations. In China, where many cards end up, dead PCs are valued for their copper, aluminum, and gold. But primitive extraction methods mean that lead and other toxins leach into the soil and water.

Initially, the California legislation aimed to make companies responsible for recycling their own products—akin to a law recently passed in the European Union. U.S. companies successfully fought that version, arguing it would burden them with a \$30-per-computer cost at a time when sales remain weak.

Environmentalists expect that even a diluted bill will have some bite. Starting in 2007, it will be illegal to sell devices

in California that do not conform to EU rules mandating a gradual phaseout of toxic materials. Moreover, every 10 years, tech companies will have to disclose the levels of hazardous materials in their products.

Tech outfits for the most part seem signed to the new reality. Says David Thompson, Panasonic's director of environmental affairs: "Manufacturers do care about how they're perceived." They'd better if high tech hopes to regain its green reputation. ■

—By Ben Elman in San Mateo, Calif.



Deconstructing The Scrap Heap

4

POUNDS
Amount of lead in a typical PC

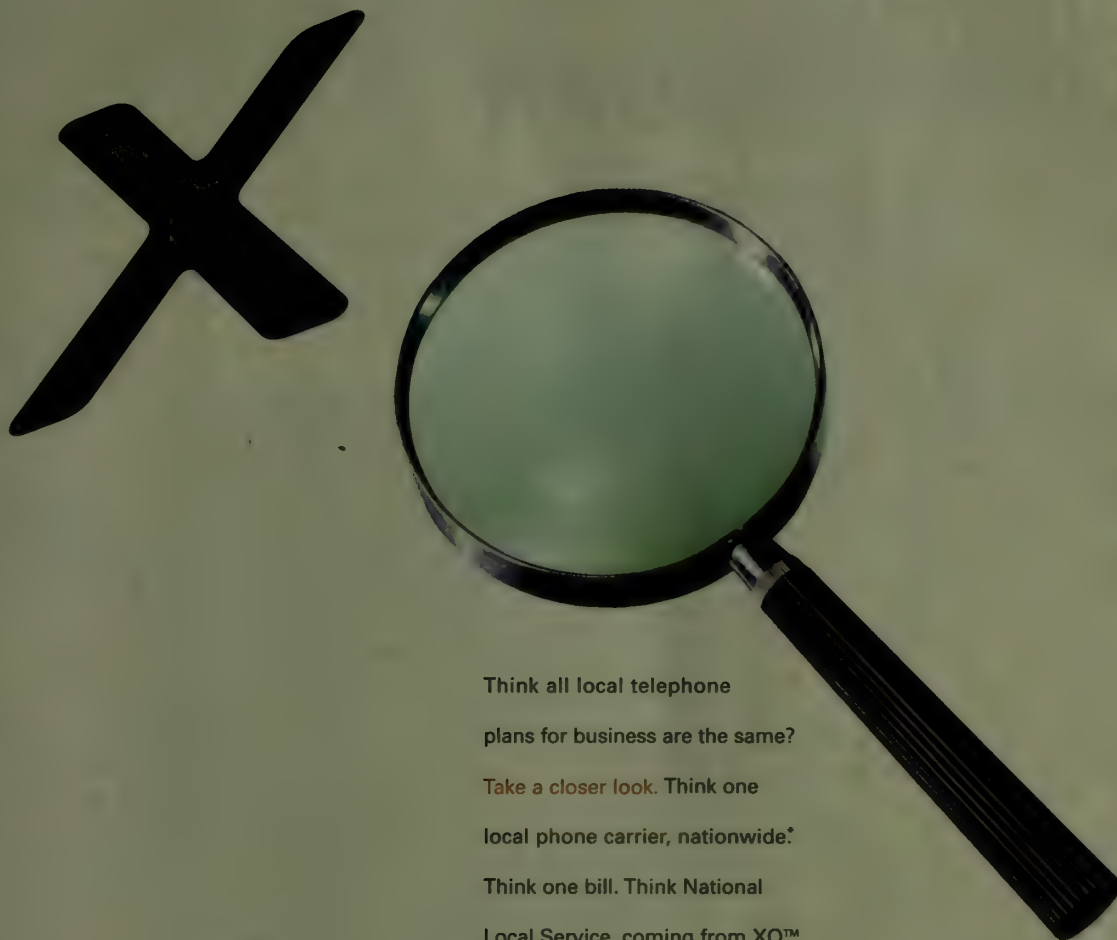
50

PERCENT
U.S. electronics waste sent overseas

63

MILLION
U.S. PCs expected to be junked this year

Data: Stanford Resources Inc.; Basel Action Network; Silicon Valley Toxics Coalition



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UNEMPLOYMENT

BLUES FOR A COMPANY TOWN

R.J. Reynolds' latest layoffs will leave a gaping hole in Winston-Salem's economy

EVER SINCE RICHARD Joshua Reynolds began selling chewing tobacco in 1875, Winston-Salem, N.C., has been the quintessential company town. As recently as the 1960s, one in every five workers was an employee of R.J. Reynolds Tobacco Co., with many pulling double shifts in the squat brick factories that dot the leafy community. The Reynolds name and influence was stamped on everything from schools to roads to a medical school.

Reynolds could be like a stern father—for years it banned long hair and frowned on divorce—but that didn't bother locals who earned as much as \$60,000 a year at the company's factory in nearby Tobaccoville. "I've gotten a lot of checks over the years from customers that they'd stamped with the words 'Tobacco Pays My Bills,'" says Penny Terry, who runs a furniture store near the plant.

Now, the Reynolds era is coming to an end in Winston-Salem. On Sept. 17, the company announced that it is laying off 40% of its workforce—some 2,600 people—in response to rising competition from discount cigarette makers using cheaper foreign tobacco. "There's great pain and some shock, too," says David M. Hughes, senior pastor at the First Baptist Church on Fifth. "The area has depended on Reynolds for generations and thought it would always be there."

The announcement rocked a town that already has suffered a steady loss of manufacturing jobs to low-wage nations such as China and Mexico. The Reynolds layoffs are particu-

UP IN SMOKE
The town has already suffered a factory exodus



Butting Out

RJR employees in Winston-Salem (N.C.) area

1983
14,000

2004*
3,500

* Estimate after layoffs announced on Sept. 17
Data: R.J. Reynolds Tobacco Co.

larly onerous. While city officials predict that new service jobs, especially in health care, will help, these positions will pay nowhere near what a production worker made at Reynolds. Similarly, many Reynolds managers and white-collar workers will have a hard time finding comparable jobs locally and are likely to move to other cities. As a result, say economists, Winston-Salem is in for a tough adjustment. "Even if we get these new health-care jobs, we're probably going to lose all of our growth for the next five years," says Don Jud, an economist at the University of North Carolina at Greensboro.

What concerns economists such as most is the cascade effect as the Reynolds layoffs ripple through the area. Before the tobacco workers made double or triple the local average manufacturing wage of \$13.50 an hour, they were able to support a thriving service industry—restaurants, dry cleaners, day care. As laid-off Reynolds workers and managers cut their spending, local businesses were forced to lay off as many as 3,000 people. That could push local unemployment above its current rate of 5.5%.

The Reynolds layoffs will take place over six months, but Winston-Salem is already bracing for the worst. Mortgage foreclosures are on the rise, and real estate agent Sharon Collins predicts that business closures will double in the next year. At Town and Country Restaurant, owner George Moutos says he gets 40% of his business from Reynolds plant, including "a couple hundred steak dinners" for Christmas parties.

"SLAP IN THE FACE"

THE PAIN IS also spreading to tobacco fields. Growers, already hurt from a 55% plunge in production since 1999, are bracing for further losses to cheaper foreign crops next year. Many are hoping for legislation now before Congress that would require manufacturers to buy growers as much as \$18 billion over the next six years to ease the switch to other crops. Reynolds is fighting the bill—a deeply unpopular position. "That's another slap in the face of farmers," says McGee Greene Jr., who grows 14 acres of tobacco in nearby Walnut Cove.

Farmers aren't the only ones facing change. Retraining will be key for many workers, but a cigarette maker won't easily segue into a career as a lab assistant. "I'm 50 years old and worked there 25 years," says a Reynolds worker who was laid off on Sept. 22. "What am I supposed to do next?" Making matters worse, local community colleges lack the resources to handle the growing ranks of unemployed. "We've had a couple hundred workers we've had to turn away," says Larry Keen, who oversees worker retraining at N.C. Community College System.

In a simpler time, tobacco was a mainstay for growers and cigarette makers alike. But these days, economic pain runs deep along Tobacco Road. ■

—By Dean Foust in Winston-Salem, N.C., with Brian Grow in Chicago



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EDITED BY MONICA ROMAN

HEADLINER

DAVID NEELEMAN



TURBULENCE, THAT'S ALL

Since **JetBlue Airways** took off in early 2001, CEO David Neeleman has been able to do no wrong. He expanded his New York upstart from coast to coast, winning customer plaudits for its bargain fares and in-flight TV. And he made money doing it. But now, Neeleman has been humbled. On Sept. 22, the Electronic Privacy Information Center accused JetBlue of violating its own privacy policy by giving a defense contractor passenger data last year as part of a security project. The nonprofit group filed a complaint with the Federal Trade Commission and asked it to investigate. A day later, JetBlue was facing a civil suit.

Neeleman, 44, moved fast. He zapped e-mail apologies to irate customers and hired **Deloitte & Touche** to review what went wrong. "I take responsibility," he says. "It won't happen again." But with no sign that the flap will hurt traffic, investors sloughed it off: JetBlue stock hit \$60.50, an all-time high, on Sept. 23, as it joined the Standard & Poor's Midcap 400 index.

—Michael Arndt

DO-NOT-CALL GETS HUNG UP

The do-not-call list has been put on hold. On Sept. 23, a week before the list was to take effect, a federal district judge in Oklahoma ruled that the Federal Trade Commission had no authority to establish the registry, which attracted some 50 million people seeking to block unwanted calls. But 50 million people can't be wrong, especially when politicians are in the mix. **House Energy & Commerce Committee** Chairman Billy Tauzin (R-La.) and ranking member John Dingell (D-Mich.) say they'll move quickly to give the FTC new power. Still, telemarketers vow to take the battle to the U.S. Supreme Court.

THE SON ALSO RISES?



The Murdoch dynasty may soon control the English skies. If his father has his way, James Murdoch, **News Corp.** Chairman Rupert Murdoch's 30-year-old son, will become CEO of News Corp.'s 34.5%-owned **British Sky Broadcasting Group**. James, who currently runs News' Asian-based Star TV satellite service, would succeed BskyB's longtime CEO Tony Ball, who will remain a consultant through May, 2004. The BskyB board

said independent board members will choose a successor to Ball, who sources say recently had disagreements with Murdoch, the board's chairman. BskyB's stock slid amid concerns about the younger Murdoch's relative lack of experience.

NOT QUITE EASY STREET

Are the boom times back on Wall Street? On Sept. 23, **Lehman Brothers** and **Morgan Stanley** reported third-quarter profits double those of the year before, and **Goldman Sachs'** profits jumped 30%. But investment bankers aren't high-fiving each other just yet. Bond trading helped boost most firms' bottom lines. Revenues from underwriting stocks and advising on mergers improved only slightly. Morgan Stanley and Goldman both told investors that their equities businesses are picking up. While the Street has definitely entered a recovery mode, it's not yet a strong rebound.

MUY GRANDE BROADCASTER

On Sept. 22, the Federal Communications Commission approved a controversial \$3.5 billion merger that will create the largest Spanish-language media conglomerate in the U.S. Leading Hispanic cable and broadcast TV network **Univision Communications** will team up with the No. 1 Spanish-language radio chain **Hispanic Broadcasting** to compete for the eyes and ears of the nation's 38 million Hispanics. The 3-to-2 vote split along partisan lines. The Republican majority, led by Chairman Michael Powell,

argued that the merger would enable the Spanish language giant to compete better with mainstream U.S. media. Some Hispanics in Congress opposed the deal on the grounds that Univision, led by a non-Hispanic chairman, would have too much control over the U.S. Hispanic media.

ET CETERA...

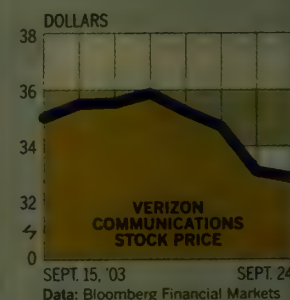
» **Nintendo** cut the U.S. price of its Game Cube console a third, to \$99.

» The U.S. Justice Dept. indicted **PurchasePro** executives allegedly inflating revenue a scheme with **AOL**.

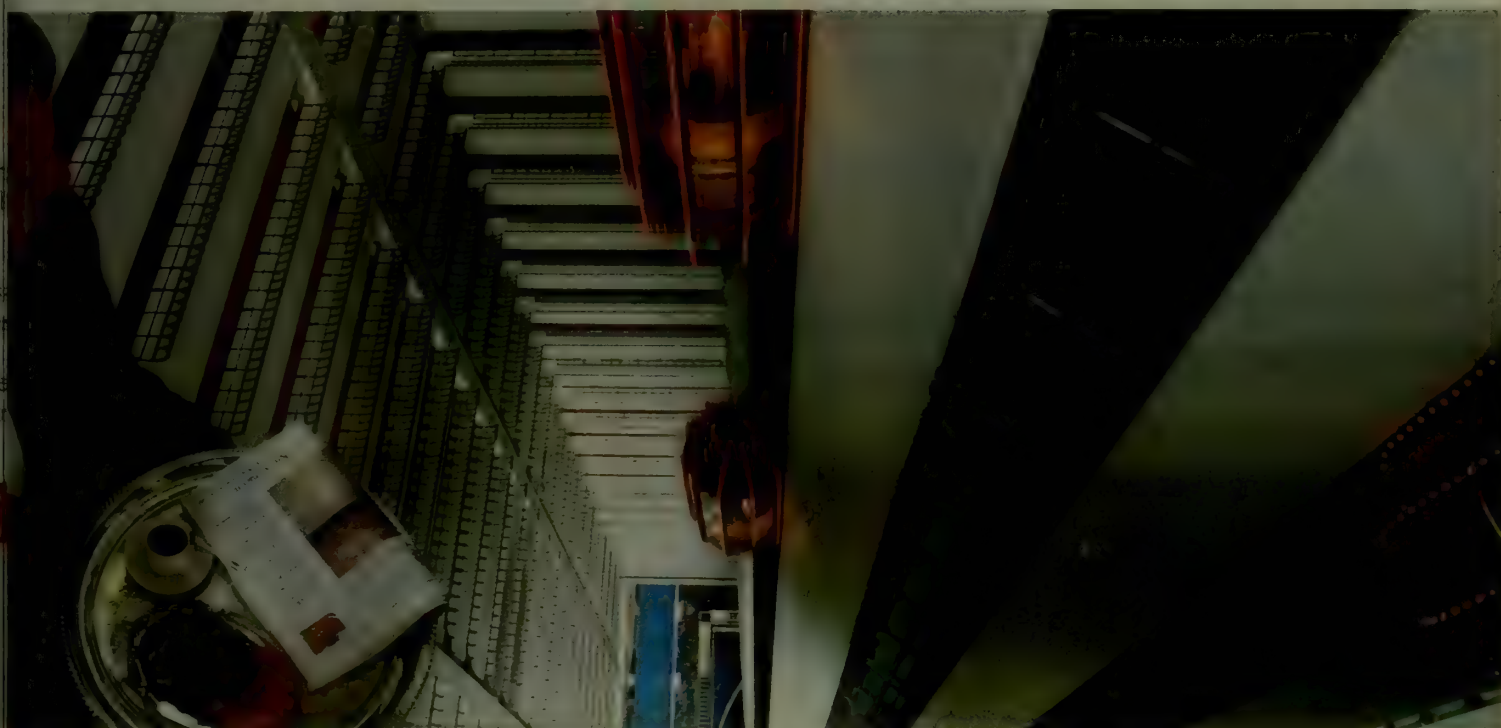
» **Cisco Systems** authorized the buyback of \$7 billion of its common shares.

CLOSING BELL

Times are still tough in telecom. Citing weak demand, **Verizon Communications** on Sept. 23 lowered its 2003 earnings forecast to a range of \$2.56-\$2.60 a share. That's down from an earlier \$2.70-\$2.80. Verizon shares slid 4.6%, to \$33.13, on the news.



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Dubai has taken just 30 years to reach income levels comparable with the world's leading industrialised nations. Some say because the city is perfectly positioned serving an area that contains a population of over 1.6 billion people with a net GDP in excess of \$1,1 trillion. Others say Dubai's wealth lies in its natural resources. But it's only once you've visited Dubai, and shared the experiences of its people that you discover the true source of the city's wealth. To know more visit www.dubaexpect.com



EDITED BY RICHARD S. DUNHAM

The Presidential Primary Goes National

This is the time when Presidential hopefuls normally spend most of their waking hours at house parties in New Hampshire and country cafés in Iowa. So why did retired General Wesley K. Clark schedule his first campaign stop in Fort Lauderdale? And why did former Vermont Governor Howard Dean recently

travel around to Seattle, Portland, Ore., and San Antonio, deep in the heart of the South country?

In both cases, it's because the primary process has become nationalized. Rather than ignoring Iowa and New Hampshire, these two cyber-charged insurgents are leveraging their national buzz to help them in the early states. The idea: The national momentum boosts their standing with early primary voters. And their rising poll numbers in Iowa and New Hampshire then propel them to later prominence. "It all feeds on itself," says Charles E. Cook Jr., editor of the nonpartisan *Cook Political Report*.

ON THE NET, STUPID

THE NEW APPROACH is bringing not only strategies but also the media. There's less catering to local interests than in Iowa's ethanol industry. "I don't believe there will be a regional [primary] campaign, focused on local issues," says Dean campaign manager Joe Trippi. Instead, the new-wave candidates are focusing their fire on the incumbent and defining themselves nationally before Bush can begin his \$200 million ad blitz. After two campaigns in which the Internet was, at best, a peripheral factor, it has become an important tool for fundraising and organization. Effective Web strategies have helped fuel the outsider candidacies of Dean and Clark while the half-dozen Washington insiders in the race continue to run traditional,

consultant-heavy campaigns.

Money and support built one mouse click at a time could help Dean or Clark avoid the fate of past insurgents such as Gary Hart. In 1984, the then-senator from Colorado stunned front-runner Walter F. Mondale in New Hampshire but couldn't compete with the Mondale machine in the delegate-rich contests that followed.

Thanks to two draft-Clark Web sites that have been collecting pledges of cash and support, the former NATO commander has an instant crew of national volunteers. And out of Dean's 400,000-strong army of volunteers, some 100,000

were recruited through Meetup.com—a Web site that brings together people with common interests. Dean is using this national reach to build support in still-vital New Hampshire: Attendees at Dean meetups wrote letters to 50,000 undecided voters there. "It's hard to overstate the importance of what Dean is doing," says Simon B.

Rosenberg of the centrist New Democratic Network. "His campaign had the insight early on to realize there were people outside of New Hampshire who could help."

Of course, predictions that the Net would revolutionize politics are nothing new. And while maverick John McCain raised millions via the Web in 2000, he couldn't overcome the organizational advantage built the old-fashioned way by Bush. Dean and Clark are shaking up the Establishment by nationalizing the primary process, but will that make them more than just political pioneers?

By Alexandra Starr



A DEAN MEET-UP
One out of four volunteers signed up on the Web

CAPITAL WRAPUP

THE UNKINDEST CUTS OF ALL

CONGRESSIONAL Republicans are taking President George W. Bush's demand that they hold the line on spending seriously: They're cutting his pet projects.

With the budget bleeding red ink and the White House seeking an additional \$87 billion for Iraq and Afghanistan, the President says he won't accept other spending bills for fiscal 2004 that total more than \$784.7 billion. That puts a squeeze on popular programs from highways to medical research.

But rather than target their own pork, usually compliant Hill Republicans are making the Administration feel the pain. A few examples: The Senate Appropriations Committee trimmed Bush's request for higher education Pell Grants by \$538 million, slashed funding for the Yucca Mountain nuclear waste dump, and refused to provide a dime for a Bush-backed drug-abuse-recovery program. House appropriators also cut the President's request for a favorite school-mentoring program. The real attention-getter: The House panel slashed \$4 million from the White House's own operations.

Soon, the White House and Congress will cut deals, and some funds will be restored. But for now, GOP lawmakers are sending a clear message: They are not going to take big hits to their favorite programs while protecting those of a President who is slipping in the polls.

By Howard Gleckman

Even the White House operating funds got trimmed

AUTOS

THE ASIAN INVASION PICKS UP SPEED

Japanese and Korean auto giants are making a big push in Europe—and grabbing share fast

LIVIO LUMBROSO WOULD have cringed in embarrassment 10 years ago to be seen driving in Paris behind the wheel of a Japanese auto. But when it came time this year to replace his Volkswagen Golf, the 32-year-old Frenchman found himself attracted to Toyota Motor Corp.'s fetching new Yaris subcompact. It had a snappy shape, came packed with options, and at \$12,480 was more affordable than comparable European rivals such as the Renault Clio, which runs \$15,600. Lumbroso, a computer scientist, still loves European cars, but the silver Yaris was, well, irresistible. "It's the excellent quality-price ratio that appeals to me most in Japanese cars. And I really fancy the new design," says Lumbroso.

Asian autos, once scorned by haughty European consumers, are suddenly chic. Across the Continent, from the ancient alleys of Rome's historic center to the German autobahn's majestic ascent into the Bavarian Alps, Japanese and Korean autos weave and sprint alongside powerful national brands. During the 1990s, Japanese auto makers' No. 1 priority was winning

big in the U.S. market. In Europe, they maintained low-key operations, and invested little. Market share hovered around 10% to 11% for a decade. Now, flush with their success in the U.S., where they've conquered a 29.1% share, they are ready to tackle Europe, the world's most competitive auto arena. What's more, the European Union in 2000 removed restrictions on Japanese car imports.

JAPANESE DNA, EUROPEAN STYLE

JUST AS THEY DID in the U.S., the Asian carmakers are investing in new, state-of-the-art plants. Toyota is spending \$1.7 billion jointly with Peugeot on a factory in the Czech Republic that will start operating in 2005, bringing its total investment in Europe to \$5.1 billion. The Japanese carmaker projects sales of 800,000 cars in Europe in 2003—reaching its 2005 target two years early—and aims to sell 1.2 million cars in the region by 2010, outstripping Italy's Fiat and matching Ford Motor Co. Nissan Motor Co. is investing \$460 million over the next two years to double output in Spain, and Hyundai is scouting sites in Eastern Europe for a \$1.1 billion plant. "The Asians see Europe as

an important battleground," says Ben M. Bensaou, a professor of technology management and Asian business at INSEAD, the European Institute of Business Administration in Fontainebleau. "They realize if they want to be in the big league globally, they have to be a strong player in Europe."

The investment is starting to pay off. Sales of Japanese brands in Western Europe rose 7.4% during the first eight months of this year, while the overall market shrank by 2.2%. Steady gains over the past two years helped boost Japan's market share in Europe to 12.4%, up from 10.7% in 2001. Korean auto makers also won new ground as sales in Europe zoomed this year by 18.4%. Hyundai Motor Co. now boasts a 1

Asian Carmakers Rev Up

They're boosting sales in a market that's down 2.2% overall.



TOYOTA
+5.4%



HONDA
+9.5%



NISSAN
+6.0%

Percent change in European sales, Jan. - Aug.

TRES CHIC
A Toyota Yaris
in Paris



market share, neck-and-neck with VW's
Audi brand. By contrast, nearly every ri-
European, except Citroën, lost ground
year. Toyota, at 4.7%, has overtaken
German stalwarts Audi and BMW.

It's not just a matter of price. Asian car-
makers are master-
ing the art of Euro-
pean automobile
allure, too. They
are building up lo-
cal design centers,
tapping into the
hottest talent pools
from Barcelona to
Munich to London.
"We want to build
a car with Japanese
DNA in line with

the tastes of European customers," says
Mario Canavesi, senior vice-president for
sales and marketing in Europe at Nissan.

The Japanese also are capitalizing on
Europeans' love affair with the diesel en-
gine. Honda Motor Co., the largest en-
gine maker in the world, spent more
than \$50 million to produce its first
diesel engine, which debuts at yearend
in the Honda Accord. Starting next year,
Honda's SUV model, CRV, will go diesel,
too. Nissan's new models, including the
hot-selling Micra, now sport Renault's
highly regarded diesel engines.

Cash-rich Toyota is the strongest
player in the pack. "We were latecomers
to Europe," says Tadashi Arashima,
president and CEO of Toyota Motor Mar-
keting Europe, who spent most of his ca-

reer building Toyota's huge presence in
North America. Since his arrival in Toy-
ota's Brussels headquarters in 1998, he
has overhauled Toyota's European car
interiors, added manual transmissions,
tailored engines and handling to more
rigorous European driving habits, and
boosted sales by 48%. "Toyota's doing a
great job. They really got it," says
Thomas Sedran, a partner at Munich
consultancy Roland Berger.

The Asians' value-for-money strategy
is a strong ace in a down economy. Japa-
nese companies rank regularly among the
top three in quality surveys in Europe. Re-
liability plus more options at a lower
sticker price is winning converts from
Opel and Ford to VW and Fiat: "People
know that apart from the servicing they

HYUNDAI
1.3%



Data: European Association of
Automobile Manufacturers

are not going to have any extra costs with these cars," says Hubert Vogel, owner of Autohaus Vogel in Esslingen, Germany, near Mercedes-Benz factories.

Some industry experts remain skeptical that the Asians can carve out a much bigger slice of the European market, arguing that their current gains are simply the result of introducing new models. As European rivals pump out hot new products, their gains could evaporate. And the Asians are most competitive in the small-car segments where margins are razor-thin. "We think sales will fall back. They won't be able to meet their aggressive targets," says Colin Couchman, senior market analyst at Global Insight Automotive in London.

The Japanese are almost nonexistent in Europe's hot luxury car market, where margins are rich and German brands like Mercedes-Benz, BMW, and Audi dominate. Toyota's upscale Lexus brand, which has been so successful in the U.S., lacks the brand cachet, styling, and interiors to appeal to more

image-conscious European luxury car buyers. It also fails to match the German rivals in introducing hot new automotive technology, including handling finesse for more aggressive driving habits. "The Europeans will defend their

So far, the Asians are not a factor in the luxury segment

ground very very strongly," says Dominique Turpin, professor of marketing at IMD in Lausanne, Switzerland.

Still, it would be folly to underestimate the Asians. Japanese manufacturers' core strength is developing new models rapidly and producing small batches efficiently. As their production base in Europe grows, they may start to wield their ability to churn out hot niche models faster than the competition. Other executives say the real worry is the relentless pressure the Asians could exert over time on margins, especially if the euro remains strong. "The question is, what does the average compact car sell for in Europe in seven years' time?" says Volkswagen CEO Bernd Pischetsrieder. Squeezing out a profit on mass market models, already a pitiless task, is about to get that much tougher. ■

—By Gail Edmondson in Frankfurt, with Brian Bremner in Tokyo and bureau reports

THE INTERNET

GLOBAL DOWNLOADING LOCAL LAWSUITS

Hauling U.S. file-sharers to court won't stop the flow of free tunes from overseas

IT TOOK A COUPLE OF NANoseconds for news of the U.S. music industry's legal assault on file-swappers to reverberate across the Atlantic—and the reaction was shrill even by online standards. "World War III will be fought over the telephone lines," declared one young German on a Web forum devoted to "the war for digital freedom." Another young man warned darkly that he would "behave like a terrorist," although he decided that first he would "go chug down a beer."

The Internet discourse, overblown and juvenile as it may be, demonstrates that illegal file-sharing isn't just a U.S. problem. Even if the Recording Industry Association of America makes good on its threat to sue thousands of people who are distributing pirated material in the U.S., it will hardly be able to choke the supply of free tunes. "You can't stop this digital revolution," warns Kim Schmitz, a former hacker from Germany.

SCARE TACTICS

THE RIAA's strategy sounds reasonable. The theory is that 90% of the illegal content comes from a core of dedicated users of file-sharing software such as Kazaa. If the RIAA can scare those hardcore sharers with lawsuits, it might disrupt the whole network.

The Web, though, really is worldwide. Even if the record companies shut down Americans who provide free songs, downloaders can get the same material from overseas sources. Users of Kazaa,

Grokster, or BearShare have no way of telling whether the songs they're taking come from Frankfurt, Germany, Frankfurt, Kentucky. "A downloader is just a downloader," says Carl, a 21-year-old student in Australia.

Youth culture is as global as the Internet. That's especially true in Europe, where young people listen to many of the same bands as their American counterparts, and a healthy 10% of homes have the high-speed Net links essential for file-sharing. While file-swapping is not epidemic in Europe as in the U.S., it is growing fast. About 6.4 million Germans over age 10 downloaded music last year, up 31% from the previous year.

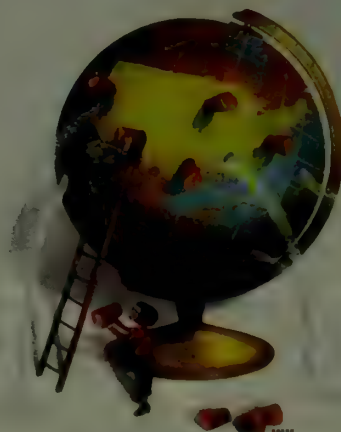
Going after the downloaders in Europe could also be more complicated outside the U.S. American law makes it relatively

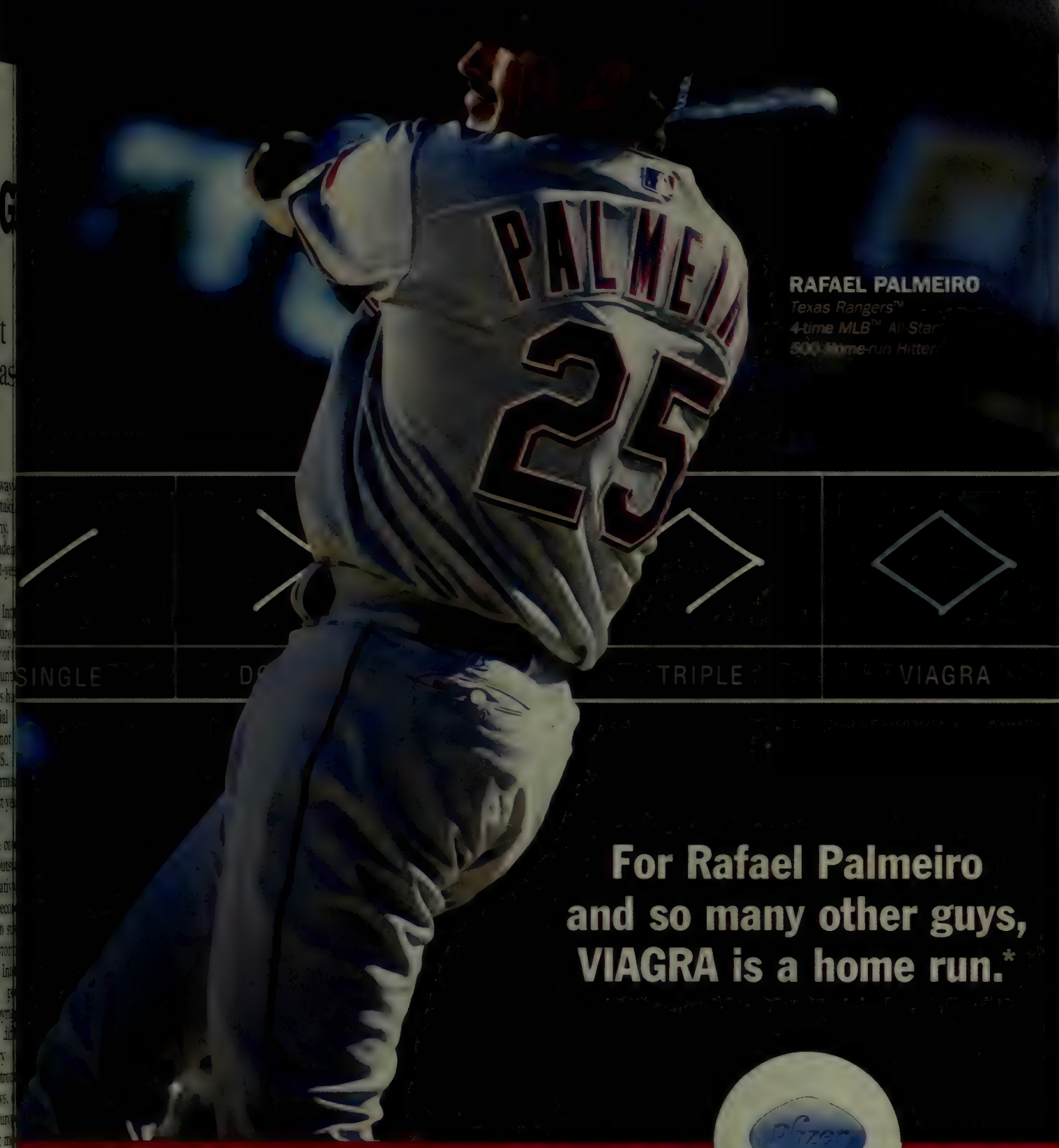
easy for the recording industry to sue a poena customer for records from Internet service providers. But copyright protections differ from country to country, and stronger privacy laws, especially in Europe, might make it more difficult to identify illegal sharers.

Abroad, the music industry also worries

about strong-arming customers, who cause potential buyers have fewer legal ways of getting music online than in the U.S. So until the industry can deal with these tough issues internationally, it can't block the front door for U.S. sharers, plenty of tunes will come in through the worldwide window of the Internet. ■

—By Jack Ewing in Frankfurt and Heather Green in New York





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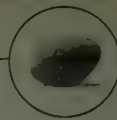
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Please see patient summary of information for VIAGRA (25-mg, 50-mg, 100-mg) tablets on the following page.

VIAGRA is indicated for the treatment of erectile dysfunction. Remember that no medicine is for everyone. If you use nitrate drugs, often used to control chest pain (also known as angina), don't take VIAGRA. This combination could cause your blood pressure to drop to an unsafe or life-threatening level. Discuss your general health status with your doctor to ensure that you are healthy enough to engage in sexual activity. If you experience chest pain, nausea, or any other discomforts during sex or an erection that lasts longer than 4 hours, seek immediate medical help. The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less commonly, bluish vision, blurred vision, or sensitivity to light may briefly occur.



PATIENT SUMMARY OF INFORMATION ABOUT

VIAGRA
(sildenafil citrate) tablets

This summary contains important information about VIAGRA®. It is important to take the place of your doctor's instructions. Read this information carefully before you start taking VIAGRA. Ask your doctor or pharmacist if you do not understand any of this information or if you want to know more about VIAGRA.

This medicine can help many men when it is used as prescribed by their doctors. However, VIAGRA is not for everyone. It is intended for use only by men who have a condition called erectile dysfunction. **VIAGRA must never be used by men who are taking medicines that contain nitrates of any kind, at any time. This includes nitroglycerin. If you take VIAGRA with any nitrate medicine your blood pressure could suddenly drop to an unsafe or life threatening level.**

What Is VIAGRA?

VIAGRA is a pill used to treat erectile dysfunction (impotence) in men. It can help many men who have erectile dysfunction get and keep an erection when they become sexually excited (stimulated).

You will not get an erection just by taking this medicine. VIAGRA helps a man with erectile dysfunction get an erection only when he is sexually excited.

How Sex Affects the Body

When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

How VIAGRA Works

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

VIAGRA Is Not for Everyone

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates—either regularly or as needed—you should never take VIAGRA. If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children, or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

What VIAGRA Does Not Do

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV—the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

What To Tell Your Doctor Before You Begin VIAGRA

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you:

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, heart attack or narrowing of the aortic valve)
- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems

- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

VIAGRA and Other Medicines

Some medicines can change the way VIAGRA works. Tell your doctor about **any medicines** you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies.

- Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*).
- If you are taking alpha-blocker therapy for the treatment of high blood pressure or prostate problems, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as you take your dose of alpha-blocker.
- If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*.)
- VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

Finding the Right Dose for You

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period. If you are taking alpha-blocker therapy, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as your dose of alpha-blocker.

How To Take VIAGRA

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

Possible Side Effects

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

Accidental Overdose

In case of accidental overdose, call your doctor right away.

Storing VIAGRA

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at 25°C (77°F); excursions permitted to 15–30°C (59–86°F) [see USP Controlled Room Temperature].

For More Information on VIAGRA

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com, or call 1-888-4VIAGRA. 23-5515-00-6 Rev. 6 Sept. 2002

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ANOTHER BIG REASON CHINA WON'T REVALUE

Already awash in bad loans, its Big Four banks could go under if depositors bolt

WE KNEW CHINA'S banks were sick. But we didn't know they were this sick. That, in essence, is the latest lesson from the debate over revaluing China's currency. Beijing doesn't want the yuan to strengthen, since it could hurt the export machine that employs hundreds of millions of Chinese. At least, that's the line China has taken in public skirmishes with the U.S. and Japan. But Beijing doesn't dare stress another huge reason for its fierce defense of currency policy: its shaky financial system. Instead, it has taken outside players—such as Standard & Poor's Corp. and a number of economists—to point out the elephant in the living room. Among all the major economies, China has the sickest banking system. And this at a time when China's economy is growing 7% a year. It has long been known that China's state-run banks are saddled with billions in loans that will never be repaid. Chinese of-

ficials are aware of this. But the latest warning was an especially loud wake-up call. In a rating note published Sept. 15, S&P said that confidence in China's banking sector is so low that volatility from a revaluation could pull its big banks under. Officially, only 21% of Chinese loans are nonperforming, but S&P puts the number at closer to 45%. Says Ping Chew, a director of S&P in Singapore: "We are afraid the banks will go bankrupt."

This sounds counterintuitive. After all, it's widely accepted that the yuan is undervalued by up to 40%, so if it gains in value by that much, why should that threaten the banks? One reason is that a jump of that size would hurt some of the banks' biggest borrowers by wiping out exporters' profits. If heavily leveraged firms can't

service their loans or borrow new money, that could bring China's growth to an abrupt halt.

Also, a revaluation would increase pressure on China to loosen capital controls further. If Beijing caves on this point, speculators could eventually move their money offshore where it can earn a higher return. Many local Chinese, aware of their banks' ill health, would also use looser capital controls to swap into U.S. or Hong Kong dollars. Nobel prize-winning economists Joseph E. Stiglitz and Robert A. Mundell both warned in mid-September of a collapse in liquidity if China tampers with the yuan prematurely.

WORSE THAN JAPAN

SUCH DIRE SCENARIOS may be academic: The Chinese won't revalue, right? But the discussion underscores just how fragile things are. China's Big Four banks—Bank of China, China Construction Bank, Industrial & Commercial Bank, and Agriculture Bank—hold 70% of China's total savings of \$3 trillion. But that's long been used to subsidize money-losing state companies. Andy Rothman, China head of Hong Kong-based investment bank CLSA Asia Pacific Markets, says that even if the banks recover as much as 20¢ on every dollar of bad loans, the remainder would still amount to 30% of gross domestic product. "As a share of GDP, it's a bigger problem than Japan," he notes.

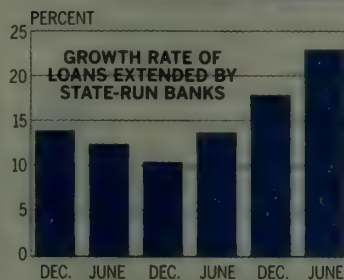
It gets worse. Despite a commitment to reform, China still lacks competent lenders. Banks have been making more loans to private enterprises and to smaller businesses. Yet one foreign banker estimates that 70% of such loans go sour because the borrowers are corrupt or simply don't know how to run a business. Beijing has been claiming lately that the ratio of bad loans to total loans is falling. That claim is misleading. The volume of new loans is growing so fast that the percentage of old bad loans is bound to fall.

Can China create a viable bank system? Yes, if it appoints bankers who base loans on careful risk assessments. Few experts, unfortunately, see much chance of that anytime soon. But the rancorous debate over the yuan makes it clear China can't put off fixing its broken banks forever. ■

—By Frederik

Balfour in Shanghai

CHINA'S CREDIT DELUGE



Data: J.P. Morgan Chase & Co.

COMMENTARY

BY JOHN ROSSANT

The Real War Is France vs. France

Resentment of the U.S. is being challenged by a growing cadre of French thinkers

OUR WAR WITH FRANCE." That was how *The New York Times* titled a Sept. 18 column by Thomas L. Friedman criticizing the French government's stance on Iraq. "France is not just our annoying ally," writes Friedman, one of the newspaper's leading voices on foreign affairs. "It is not just our jealous rival. France is

becoming our enemy." Friedman's views, reprinted word for word in Paris daily *Le Monde*, seemed to confirm the view of many French: The U.S. has become a warmonger, intent on crushing France for daring to be independent.

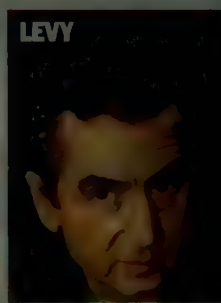
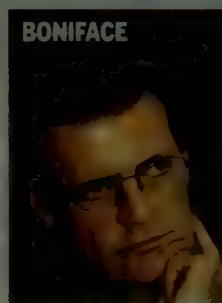
Plenty of French resent America these days. But if you think French public opinion is monolithically anti-American, spend some time exploring French media and you'll quickly discover that the French are much more divided about *les Américains* than *les Américains* think they are. The real war is France vs. France, even though the issue is American power—whether France should oppose it, support it, or somehow accommodate it. As Paris and Washington find themselves with diplomatic daggers drawn once again—this time on the issue of the U.N.'s role in postwar Iraq—French opinion back home is more sharply divided than it has ever been. That division says far more about the crisis in France's identity than the faults of the U.S.

Take a look at the nonfiction best-sellers on display at the giant Fnac Champs-Élysées store. On one side, violent attacks on America, either because it's an overbearing colossus—as political scientist Pascal Boniface argues in his *La France contre L'Empire* (France against the Empire—guess which one)—or because it's a decadent, collapsing giant, as in Emmanuel Todd's *Après l'Empire* (After the Empire).

But you'll find that the anti-anti-Americans are out in force, too. Bernard-Henry Lévy, André Glucksmann, and Jean-François Revel, among others, see anti-Americanism as the default mode among French intellectuals, one that can often slide seamlessly into anti-capitalism and anti-Semitism. These critics may not be fans of every U.S. policy, but they reserve their most withering judgments for posturing French public figures, such as Foreign Minister Dominique de Villepin. September 11, for Glucksmann, was nothing less than a declaration of war against democracy: "The question of questions is not multilateralism or unilateralism but

Culture Skirmish

The French intellectual Establishment is dividing into two distinct camps. Here's how they stand on some hot-button issues:



THE ANTI-AMERICANS

THE ANTI-ANTI-AMERICANS

AMERICA

■ The Great Satan

■ Beacon of Freedom

CAPITALISM

■ Essentially evil

■ The only way

ISRAEL

■ A proxy for the U.S.

■ Must be supported

GLOBALIZATION

■ Non!

■ Oui!

nihilism or civilization." Just the kind of strong words the French love, which is why these tomes are flying off the shelves. "The only really popular theme is America," says a Fnac saleswoman. "That and whether France is declining."

In a way, it's the same theme: power and the lack of it. American diplomatic and military stridency underscores the relative powerlessness of France. Thus the French pine for the days when Charles de Gaulle could flamboyantly pull France and its nuclear-tipped missiles out of NATO, while at the same time, according to recent polls, some 72% see their nation in decline. "For the first time in the history of our country, people are wondering whether we are still capable of great things," says Michel Crepu, head of the monthly *Revue des Deux Mondes*. That helps explain why the book with the most buzz is *La France qui Tombe* (Falling France), by historian Nicolas Baverez. It's a merciless account of how shabby the French model has become: economic growth at zero, unemployment running near 10%, and public debt approaching \$1.14 trillion, all stemming from a persistent inability to modernize. And as neither the center-right nor the center-left is willing to try real reforms, "it is the extremists who benefit," argues Baverez. Hard-hitting criticism—and as biting as anything directed against the U.S. Our "war" with France may be important, but it's the outcome of France vs. France that could determine this proud nation's course. ■

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EDITED BY ROSE BRADY

A Revolt in Seoul Could Make or Break Roh

ROH MOO HYUN was elected South Korea's President in a surprise victory last December, he vowed a sweeping overhaul of the country's graft-infested political ways. Nine months later, his most ardent supporters complain that old guards in the party are blocking progress on political reform. So on Sept. 20,

radical parliamentarians quit Roh's ruling Millennium Democratic Party (MDP) to set up a party aimed at breaking decades-old patronage system that is based on regional loyalties and incestuous ties between politicians and business. Roh is keeping his MDP membership for now, but he has made it clear that he backs a breakaway group and will probably leave the MDP in the coming months. "The political supporters of Roh are taking a high-risk, high-return gamble," says Rhee Ghan, political scientist at Kookmin University in Seoul.

The political tumult could prove to be a major distraction for South Korea as it seeks to defuse a crisis with North Korea, rebuild relations with the U.S., and ignite an economic recovery. No matter: A sizable minority of Korean activists are desperate to break the hold of the old factions on the country. The 37 MDP lawmakers teamed up with the breakaway lawmakers in the Grand National Party to form the new party, tentatively named the United New Party for Participatory Citizens. And more legislators from Internet-savvy People's

Party for Reform have vowed to join. They'll be campaigning to win a third of the seats in the 272-member National Assembly in next April's general elections. If their failure could deal a devastating blow to Roh, turning him into a lame duck a year before his term ends. That's disturbing, since South Korea badly needs a strong President. Roh's popularity rating has dropped from 70% to 40% after policy troubles ranging from

labor unrest to tension with North Korea. Now the reformists' defection has turned the remaining 64 Millennium Democratic parliamentarians into a hostile force. This group largely opposes rapid political reform. If MDP parliamentarians ally with the 149 Grand National Party members, they could quash any Roh initiative.

A NOBLE AIM

ROH'S ALLIES are betting that their bold reform push will draw widespread support from jaded voters in the general elections. Candidates from the United New Party would attempt to win favor by shunning the practice of buying votes.

And the party will aim to overcome the regionalism that has been key to the patronage system. "The rivalry based on regional loyalty has made it impossible for politicians to focus on key national issues. We want to break the deadlock," says Lee Bu Young, a former Grand National Party lawmaker who joined the new party.

That's a noble aim. But it's questionable whether enough voters will back it. A Sept. 20 poll showed that 16.9% of voters would support the new party, while 16.5% support the Millennium Democrats and 25.9% back the Grand National Party. Still, it's a long time until April, and the reformists are having some effect. Both the Millennium Democrats and the Grand National Party have vowed to end deals handing candidacies to big political donors. The first steps toward cleaning up South Korean politics may finally be under way. ■

—By Moon Ihlwan in Seoul



PRESIDENT ROH
Supporting the breakaway legislators

GLOBAL WRAPUP

A REFORM CABINET IN JAPAN

AFTER WINNING reelection as ruling party chief, Japanese Prime Minister Junichiro Koizumi revamped his Cabinet on Sept. 22 to create a dream team populated by reformers. The new Finance Minister, Sadakazu Tanigaki, says he won't support public-works spending, a favorite of pork-barrel politicians, to boost economic growth. Nobuteru Ishihara, a young Turk pushing reform, will take over the influential Land, Infrastructure & Transport Ministry to privatize the money-wasting public highway system. And despite pressure from party conservatives, Koizumi retained bank reformer Heizo Takenaka as Economics Minister and Financial Services Agency chief. All this is bound to win Koizumi more support at a crucial time: Expectations are growing that he will call a snap election soon.

STOIBER'S GROWING CLOUT IN GERMANY

EDMUND STOIBER'S landslide reelection as Prime Minister of Bavaria boosts his clout in the contest to dominate the center-right on a national level. He is likely to advocate a confrontational course with center-left Chancellor Gerhard Schröder—in contrast with his rival Angela Merkel, who is chairman of the Christian Democratic Union. Merkel has called for compromises with Schröder on issues such as tax cuts and loosening labor markets. Stoiber, who nearly unseated Schröder in 2002, opposes some subsidy cuts and has favored state bailouts of industry. On Sept. 22, Stoiber declared that Schröder had "lost touch with the people." The Stoiber-Merkel rivalry could further delay economic reform.

Genentech's Medicine Man

CEO Arthur Levinson got the biotech pioneer off life support. Will it finally deliver on its promises? BY ARLENE WEINTRAUB

ON MAR. 14, HUNDREDS OF ANGRY Wall Street analysts converged on The Pierre hotel in New York and demanded answers from Genentech Inc. CEO Arthur D. "Art" Levinson. The biotech company's experimental drug, Avastin, had failed a key trial in breast cancer in September, 2002, causing Genentech's stock to nose-dive 14%, to \$27.50, in one day. Why, analysts wondered, would Levinson dream of spending a penny more to develop a product that was clearly »

STARGAZER
Levinson
relaxes at
home by
photographing
the heavens



a dog? "They said I was stupid," Levinson says. "It was like I was a charlatan selling snake oil."

The CEO isn't one to gloat. But as he prepares to file for Food & Drug Administration approval for what could be the most important drug in Genentech's history, he can't resist. Late-stage trial data released in May showed that Avastin significantly

extended the lives of patients with colon cancer. Analysts now hail the drug as a potential billion-dollar-a-year blockbuster. The agency will receive Genentech's filing on Avastin by the end of September.

Avastin is just the latest in a series of coups for the world's oldest biotechnology outfit, which was founded in 1976 in South San Francisco. In June, the FDA approved Genentech's Xolair, the first biotech drug to treat asthma. On Sept. 9, an FDA advisory committee unanimously recommended approval of the company's psoriasis drug, Raptiva, which should hit the market by December and could one day be worth more than \$400 million a year.

In short, Levinson could be on the cusp of a rare pharmaceutical trifecta. If Avastin is approved by mid-2004, as expected, Genentech will have launched three new products in a year, all of which offer entirely new methods for attacking the diseases they target. Genentech's sales of \$2.7 billion already make it the second-largest biotech after Amgen Inc., with \$5.5 billion. Analysts say its revenues could surge to \$5 billion by the end of 2005, and profits could hit \$1 billion. In anticipation, investors have bid up Genentech's stock 164% this year, to \$87—more than twice the gain of the Morgan Stanley Biotech Index.

Clearly Wall Street is placing a massive bet on Levinson, who began his career at Genentech as a scientist 23 years ago. Investors are counting on him to guide the company as it approaches an historic crossroads. Genentech is shedding its sta-

tus as a scrappy startup and seeking to become a consistent profitable pharmaceutical powerhouse. If Levinson pulls off a difficult transition, it will be the strongest signal yet that the dusty Genentech helped create more than 25 years ago is finally delivering on its promise—that it can generate a steady stream of novel drugs to conquer once-untreatable illnesses.

What investors may not realize, though, is that Levinson's thorniest challenges lie ahead. Avastin may look like a sure thing if only because of the sheer lack of life-extending drugs on the market for colon cancer, which strikes 147,500 patients per year in the U.S. But the FDA has a long history of demanding additional data on products that were supposed to be slam-dunks. What's more, Genentech's \$45 billion market cap assumes Avastin will be approved for other cancers, too, and that drugs further back in the pipeline will hit the market on time, analysts say. And in the asthma and psoriasis markets, where Genentech is a rookie, Levinson will face intense competition, not to mention the chore of persuading health plans to cover new drugs that could cost tens of thousands of dollars a year per patient.

Genentech could hit a trifecta: three new products in a year

To succeed, Levinson has to perform a perilous balancing act. He'll need to devote more resources to sales and marketing, while funneling enough into the research pipeline to project growth beyond 2004. With the stock trading at its highest level since early 2001, there is no room for screwups: One bad decision, and investors could

bail. "Clearly there's tremendous potential, but it has to translate to commercial success," says Kris H. Jenner, portfolio manager of the T. Rowe Price Health Sciences Fund, which owns shares of Genentech. "The worry is, can Genentech execute?"

If Levinson's management of Avastin so far is any gauge, 53-year-old scientist should be able to guide Genentech through this minefield. The drug was born from a theory that tumors can be starved by blocking the formation of blood vessels that feed them (table, page 78). In the development phase, there were years of disappointments that would have prom-

Biotech Pioneer

Genentech earned \$484 million* on \$2.7 billion in sales last year. Key scientific achievements include:

RECOMBINANT DNA Extracting DNA from one organism, transplanting it into another, and coaxing it to churn out therapeutic proteins.

MONOCLONAL CELL MANUFACTURING Producing large quantities of protein drugs in rodent cells—now a standard procedure.

HER2 ANTIBODY 25% of women with breast cancer overexpress a protein called Her2. Genentech developed an antibody, Herceptin, which shuts off the Her2 gene and slows tumor growth.

Hopes for colon cancer drug Avastin are lifting Genentech's shares.



Now, to meet investor's expectations, Genentech must make good on its pipeline of new drugs, which include:

AVASTIN (COLON CANCER) Could hit the market next year and earn more than \$1 billion a year.

TARCEVA (LUNG CANCER) FDA filing expected in 2004. Faces competition from AstraZeneca's drug, Iressa.

LUCEPTIS (MACULAR DEGENERATION) Now in late-stage trials, it may slow the progression to blindness.

MLN-02 (CROHN'S DISEASE AND ULCERATIVE COLITIS) Trials are in progress, in partnership with Millennium Pharmaceuticals.

*before one-time charges. Source: Genentech; Company reports; BusinessWeek



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IN THE LAB
Genentech
has to keep
funneling
resources into
the pipeline

ed most pharmaceutical CEOs to abandon the drug. But Levinson is no average CEO. When Wall Street soured on Avastin after the breast-cancer trials late last year, Levinson stood his ground, certain that good science would bring results. Behaving like a scientist, he continually reminded analysts that all cancers are different, and he steered them to promising data from an early colon-cancer trial.

Although Levinson hung up his lab coat years ago, he's still more personally involved in the science of Genentech than most top pharmaceutical execs. When scientists report on their research at weekly review meetings, Levinson often shows up unannounced and peppers them with detailed questions. "Sometimes the junior people get intimidated," says Richard H. Scheller, executive vice-president for research.

Even when Levinson relaxes at home, he crackles with goal-focused energy. In the kitchen of his suburban San Francisco home recently, he talked about his long tenure with the biotech bellwether. As he dashed from the stove to the microwave, his glasses fogged with steam wafting off his creation of pasta mixed with smoked chicken and goat cheese. Cooking, he explains, is a lot like science: You mix and match ingredients until you come up with that perfect concoction.

The Science Geek

LEVINSON HAS BEEN A SCIENCE geek for as long as he can remember. Born and raised in Seattle, he spent weeks at a stretch poring over books on physics and astronomy sent by his uncle, a librarian. As a junior at the University of Washington, he was leaning toward a career in medicine or astronomy when he be-

Levinson has long been obsessed with finding the cause of cancer

came obsessed with idea of trying to answer ology's toughest question: What causes cancer? This led to a PhD in biochemistry from Princeton University in 1977. Moving to the University of California at San Francisco, he worked in the lab of Michael Bishop and Harold Varmus, who would later share the Nobel prize for their discovery that cer-

viruses can capture genes from normal cells and convert them into cancer-causing genes. There, Levinson published a groundbreaking paper that demonstrated part of the biochemical chain reaction that causes cancer.

At UCSF, Levinson was an intense and somewhat quirky scientist. For a lab photo, Levinson once showed up dressed as a hunter, complete with toy rifle and pith helmet. His point: You need a hunter's instincts when pursuing the causes of cancer. And Varmus remembers being stunned when Levinson, an amateur computer whiz, volunteered to equip the lab with its first set of desktop computers. He even gave seminars to the scientists on how to use them. "Art is an imaginative thinker with very broad technical interests," Varmus says.

In 1980, Levinson met Genentech founder and UCSF professor Herbert W. Boyer, who offered him a chance to be one of the startup's first scientists. Some of Levinson's colleagues accu-

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him of selling out. "He took a bit of grief, because he could have gotten an academic appointment just about anywhere," Boyer recalls. "He was that good." Undaunted by the criticism, Levinson took Boyer up on his offer. From the start, he thrived in Genentech's work-hard-play-hard culture, where scientists in cut-off jeans and torn shirts worked hundred-hour weeks, then blew off steam by playing pranks on each other and carousing at the company's raucous Friday afternoon parties.

One of Levinson's first goals after joining Genentech was to find a better way to manufacture biotech drugs. The standard production method back then—growing them inside *e coli* bacteria cells—didn't work for some products, including a hepatitis vaccine Genentech was developing. So Levinson decided to try making the drug in mammal cells. After a painstaking process of trial and error, he figured out how to coax ovary cells from Chinese hamsters to churn out the drug.

When Levinson went to Genentech's accountants with his idea, they snubbed him. It would cost too much, they figured, as no one had attempted to make biotech drugs in mammalian cells except in tiny quantities for research. "I thought their calculations were fraught with problems," Levinson recounts. So he went over their heads to the chief of manufacturing, William D. Young, who embraced the idea. "The process he developed was incredible," recalls Young, now CEO of ViroLogic Inc., a South San Francisco biotech. Although Genentech licensed out the hepatitis vaccine, the company used Levinson's method to make its other drugs. Mammalian-cell manufacturing eventually became standard in the biotech industry.

Boundaries and Controls

CO-WORKERS HAVE COME TO ADMIRE another side of the CEO: financial whiz. Levinson taught himself about Wall Street as a college student and began dabbling in stocks to supplement his meager income as an academic scientist. He joined Genentech just before it went public, in October, 1980. All employees were offered 200 shares each at a 15% discount to the pre-split initial public offering price of \$35. Levinson—the only guy in the lab

Co-workers have come to admire the scientist-CEO for his finance savvy

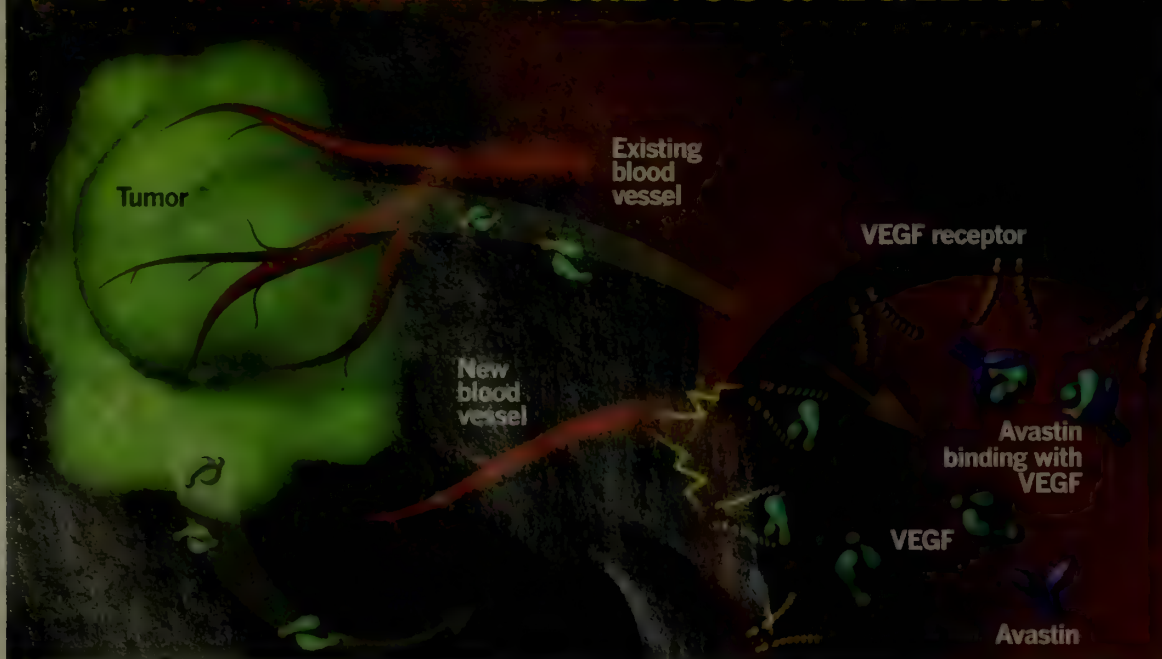
Through most of his life, the disheveled and disorganized Levinson didn't strike many people as management material. But his bosses pushed him up through the ranks, convinced that his deep experience in the lab and infectious enthusiasm for what goes on there would be an asset to the company. "He understands the heart of this business," says Franz B. Hurn, Genentech board member and CEO of Roche Group. They named him head of research in 1990. The promotion prompted Levinson's son, Jesse, then 7, to suggest that someday he might run the place. "He laughed at the idea," says Jesse, now 20. "He was a scientist, and he loved what he was doing."

There was little to love about the CEO position when Levinson was thrust into it in 1995. The former chief, G. Kirk Raab, had signed under a cloud when the company revealed that he had asked Roche for a personal loan guarantee. Genentech was also smarting from federal criminal charges that it had promoted human growth hormone for uses not yet approved by the FDA. (Genentech later pleaded guilty and paid a \$50 million fine.) Levinson called an all-employee meeting and made an emotional plea that everyone ensure Genentech would never face such accusations again. "I completely love this place," Levinson said. "It was very tough for me to see us getting beat up."

He began establishing boundaries and controls. All sales materials, for example, would have to be reviewed by Genentech

who understood market dynamics. Levinson gave his fellow scientists a tutorial and urged them to buy all 200 shares. The next day, as the stock skyrocketed to \$88 in under an hour, he advised them all to sell. "He sold; I didn't," laments former Genentech scientist David V. Goeddel, now CEO of Tularik Inc., also in South San Francisco. "It was clear he knew what he was talking about."

How Avastin Starves a Tumor



Tumors need blood, and they have a devious way to get it:

>> They secrete a protein called **VEGF** that docks with receptors in nearby blood vessels, stimulating the growth of new blood vessels.

>> Genentech foils this plot with **Avastin**, a drug that binds with VEGF and prevents that protein from attaching to receptors. New blood vessels don't form, and the tumor starves.



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legal and regulatory departments. What's more, realizing that Genentech couldn't tackle all of medicine, he focused resources on developing revolutionary treatments in three areas: immunology, cancer, and vascular biology—the study of blood vessels and their role in disease.

While colleagues and investors give Levinson high marks today, Genentech under his watch has not been free of missteps. The company made a serious error with Raptiva. As the drug entered late-stage trials, Genentech decided to ramp up production by taking over the manufacturing task for Xoma Ltd., which had been making it until that time. But the new version of the drug had a slightly different molecular structure than the original. In April, 2002, Genentech announced it would have to delay its FDA filing for six months so that it could collect data proving the new drug was comparable to the original.

Now Genentech is facing an all-out fight in the psoriasis market. Cambridge (Mass.)-based Biogen Inc. beat Genentech to the punch with a new drug it launched in January. Amgen, Johnson & Johnson, and Abbott Laboratories are expected to jump into the market, too. Genentech's plan is to bombard dermatologists with pitches highlighting Raptiva's advantages: It kicks in faster than the other drugs, and patients can easily inject it themselves. But Genentech refuses to run television ads trumpeting its products directly to consumers. Instead, Levinson prefers to let doctors explain complex drugs to patients. "These ads with people running through flowers and dancing are distasteful," he says.

"It's Going to Be Tough"

GENENTECH'S DISCOMFORT WITH TV could put it at a disadvantage to competitors such as Amgen, maker of the blockbuster drug Enbrel. That product has yet to be approved to treat psoriasis, but Amgen is already collecting potential patient names via

Genentech eschews TV ads, choosing to let doctors explain drugs

Moreover, the new drugs will be costly, potentially making Genentech a lightning rod for insurers and politicians who have been griping about rising health-care costs. The price tag on an asthma drug, for example, is about \$1,000 a month, while other treatments such as steroid inhalers cost just \$300 a month. Although most health plans have agreed to cover the products, they require patients and doctors to fill out lengthy questionnaires before determining who can get it. "They're making us jump through hoops because the price is just so high," says Brian Smart, chairman of the asthma and allergy center at the Page Medical Group in Glen Ellyn, Ill.

Even when grappling with pricing and other complexities, Levinson preserves his sense of humor. In an infamous prank two years ago, he hazed incoming research chief Richard Scheller by orchestrating a ruse in which all the top managers pretended Genentech was actually going down the drain. Scheller's first management meeting, each executive presented a fake overhead slide, complete with charts and tables, showing how poor the company's prospects were. Levinson lamented that the board would surely fire him momentarily. "They really had me," says Scheller, who had left a tenured professorship

at Stanford University to join Genentech. Scheller got back at the CEO by placing a 6-foot-tall cutout of Levinson dressed as *Star Trek's* Spock at the door of an off-site meeting and distributing hundreds of smaller copies to executives.

In the world of Big Pharma, Levinson remains an oddball. He shuns the corporate spotlight, rarely accepting invitations to speak at industry events. He would much rather be at Genentech peering at chemical assays or at home tinkering with a telescope and talking science with his wife and two children. When his son and daughter were young, Levinson used Legos to teach them about DNA, and recreated the solar system with tennis balls and a flashlight. "He's just like a little kid," says his wife, Rita.

These days, when he needs a break from the ever-mounting pressures, he picks up his digital camera to his backyard telescope and takes photographs of faraway stars. "Some people look at the stars because they like to marvel at how small we are," he says. "I'd rather marvel at how much we've learned and the possibilities that are still out there." Now, it's time for this scientist-turned-CEO to prove that he can keep Genentech's stock from falling. ■

THE CHAIRMAN AND CEO

Arthur D. Levinson

Levinson, a science whiz since childhood, is as comfortable in the lab as he is in the executive suite. His résumé says it all.

BORN Mar. 31, 1950, Seattle

EDUCATION B.S., molecular biology, University of Washington, 1972; PhD, biochemistry, Princeton University, 1977.

CURRENT POSITION Chairman and CEO, Genentech Inc.

CAREER PATH Left post-doctoral position at University of San Francisco's microbiology department in 1980 to join Genentech as one of its first scientists. Named vice-president of research technology in 1989 and head of research in 1990. Appointed CEO in 1995 and chairman in 1999.

FAMILY Married to childhood friend Rita for 24 years. Son, Jesse, is 20; daughter, Anya, is 16.

EARLY MENTORS J. Michael Bishop and Harold E. Varmus, UCSF scientists who won the Nobel prize in 1989 for research in cancer-causing genes. Levinson was a post-doc in their lab in the late 1970s.

FIRST JOB Worked night shift as shopping mall janitor for two summers in high school

MANAGEMENT STYLE Disciplined yet lighthearted. Often attends presentations by company scientists, asking detailed questions about data and study designs. Famous for playing pranks on co-workers and placing friendly wagers.

HOBBIES Astronomy, photography, music, tennis.



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INNOVATIONS

Digital diary and a supermicrobe

»» Sunglasses with a tiny, unobtrusive digital camera housed in the frame have been created by researchers at Hewlett-Packard Co.'s laboratory in Bristol, England. Many futurists predict that people will soon be recording almost every waking moment in their lives. The big problem, though, is organizing this flood of images so that a person can recall specific events months or years later. HP is tackling that, too—with software that automatically annotates the images.

»» *Chromobacterium violaceum* is a bacterium that floats along the Río Negro



River in the Amazon rainforest. While it can cause fatal infections, the microbe may also be an important new source of medicines and plastics, according to the 100-odd scientists of the Brazil National Genome Project. They have just deciphered the bacterium's genetic code, and preliminary studies indicate that its genes hold potential for fighting cancer and synthesizing acids that could be a raw material for new plastics. The gene products may also act as natural insecticides and pollution eaters. Details are to appear in a future issue of *Proceedings of the National Academy of Sciences*.



FIREFIGHTING WATER BALLOONS AREN'T JUST FOR PRANKS

WHILE TOYING around with water balloons, a manager at Boeing may have found a better way to fight wildfires. His brainchild: a 26-sided container about the size of a beachball. Made of plastic, it holds six gallons and could be dropped by the pallet load from C-17 cargo planes.

Today, small planes or helicopters are typically used to fight forest fires. They swoop in as low as 150 feet, which can put flight crews in danger. Even then, a fire's intense heat and winds can

reduce the effectiveness of water or chemical foams before they hit the ground.

Boeing's water bomblets would get around those shortcomings, says inventor William Cleary. Stacked 12 to a pallet, they could be dropped accurately from 1,000 feet or more. Like water balloons, they would burst on impact. A single C-17 could carry 2,800 containers—as much as 100 helicopter deliveries. Boeing plans to field-test Cleary's concept later this year. —Michael Arndt

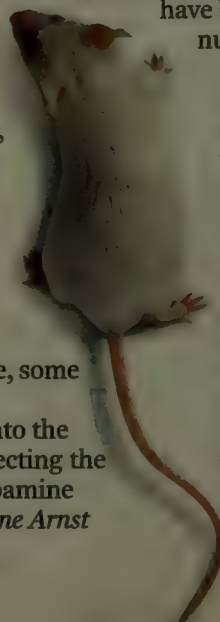
RESEARCH HARDY STEMS

SCIENCE IS A STEP closer to the day when stem cells might treat diseases. In the October issue of *Nature Biotechnology*, researchers report curing a Parkinson's-like illness in mice using dopamine nerve cells cloned from stem cells taken from the animals' tails. Dopamine-producing cells, which play a key role in cognition and movement, are destroyed by Parkinson's disease.

The research team, led by Dr. Lorenz Studer of Memorial Sloan-Kettering Cancer Center, reported in 2001 that it could generate unlimited numbers

of dopamine neurons from mouse stem cells, but the method didn't work for all animals. With refinement, their culturing technique now works for any animal—and can create neurons specific to different types of brain tissue, including serotonin cells and the so-called GABA cells involved in a range of neurological diseases.

In the case of the brain-damaged mice, some cloned cells were transplanted back into the donor animals, correcting the Parkinson's-like dopamine deficiency. —Catherine Arnst



MEDICINE IN THE WAITING ROOM

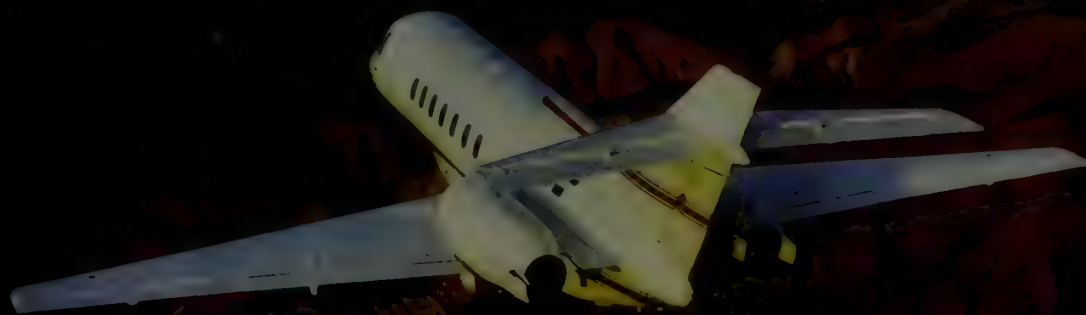
TO REPAIR FAULTY heart valves, doctors no longer have to crack open a person's chest. Surgeons now do the job through a small 2.5-inch incision. But one day, doctors will be able to mend or replace valves without any chest opening at all. The idea: thread a catheter up the femoral artery from the groin or through another blood vessel. Packaged inside the catheter is either a new heart valve or a tiny system for repairing leaky valves. Patients would be able to have the procedure in the catheter lab instead of the operating room—saving on costs and speeding recovery.

At least eight companies are developing the new cardiac technology, including giant Edwards Lifesciences and startup Percutaneous Valve Technologies. In one of Edwards' experimental products, the catheter delivers a new aortic valve and pushes aside the old one; in another, a tiny needle and thread stitches together a leaky mitral valve.

The new techniques were first tested on animals and have been tried on a small number of people, mainly in Europe. "It's still very early days," says prominent heart valve surgeon Dr. Delos M. "Toby" Cosgrove of the Cleveland Clinic—the approach has to prove that it's as safe and effective as the current surgery. But he adds: "This is really seminal work, and over time we will see this become a reality."

—John Ca

CORPORATE AIRCRAFT KEEP FLYING



A growing number of companies consider corporate airplanes to be business tools.

In an effort to reduce capital expenditures, many companies have not been buying new corporate aircraft. However, they are flying their existing aircraft more than ever to help retain and generate business.

During previous recessions, many companies gave up their airplanes, worried that shareholders would look askance at them clinging to what has been widely regarded as a perk while their profits, dividends and workforces shrank. Today, a growing number of corporations have realized that business aircraft, when properly utilized, are actually business tools that can help leaner companies hold on to customers and even generate new business.

"Although we are in the midst of a sluggish economy, operators realize that aircraft are a necessity for business because they help increase productivity," said Roger Whyte, Hessna's senior vice president of sales and marketing.

Indeed, evidence indicates that these business tools are working overtime. Robert P. Blouin, senior vice president of operations for the National Business Aviation Association (NBAA), reported that the association's members that do not rent aircraft for hire are collectively flying 5.8 percent more this year than they did in 2002.

"This is a tough time for the [airplane] manufacturers; people are not buying new [aircraft], but people are doing more with what they've got," noted Blouin. He said corporate flight departments are using creative ways of utilizing aircraft, including relying on contract pilots and flight attendants and using fractional aircraft to complement their company airplanes.

Fractional ownership continues to grow, although not at the double-digit rates of recent years. Nevertheless, Kevin Russell, executive vice president of NetJets, the leading fractional provider, noted, "In today's economic environment, many companies are realizing that the cost of competing is more expensive than ever. This is especially true in this era of increased focus on corporate compliance, shareholder diligence and the need for senior management to sign off on company financials. We at NetJets have received a number of phone calls from business America asking how we can tailor a NetJets solution to complement their needs."



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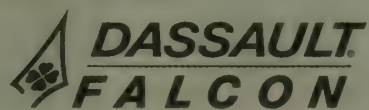
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BUSINESS AVIATION

Charter demand in certain metropolitan areas (New York, for example) is down, but charter activity is up in many other regions, especially where commercial air service has been cut. According to the National Air Transportation Association, which represents on-demand air charter operators, charter is the second-fastest-growing segment of business aviation behind fractional ownership.

Clearly, the flexibility, productivity and security offered by business aircraft are valued in the current travel environment. Although the lines at airport security check-



Business jet cabins are inflight offices

points are moving faster than when more-stringent screening procedures were instituted, the difference between the time it takes to travel on the airlines versus business aircraft has increased. Security and

health concerns (such as SARS) and reduced airline service also have convinced more people to rely on business aircraft.

Business priorities and demographics also have played a part in the increased use of corporate airplanes. "Because of all the assaults on corporate credibility, American business needs to rebuild trust," asserted John W. Olcott, an aviation consultant and former NBAA president. "You rebuild trust face-to-face; you don't do it over the phone or Internet. So the need to get out and see your best customers and business partners is greater than ever." In addition, the number of people who can afford to charter has increased as affluent baby-boomers spend more to achieve a better travel experience.

INTERTWINED ISSUES OF SECURITY AND ACCESS

The identity and intentions of business aircraft can be easily determined, but, ironically, a few government officials consider corporate airplanes to be a possible security threat, so business aircraft have been banned at Washington's Reagan National Airport since September 11, 2001.

In addition, the Transportation Security Administration (TSA) is using temporary flight restrictions (TFRs) to

prohibit access to airspace during major sporting events over theme parks or whenever the U.S. president travels. Some airport opponents have used security concerns to justify shutting down airfields, with the most notable example being Mayor Richard Daley's abrupt closure of Chicago's Meigs Field earlier this year.

Aviation advocates claim that to be most useful, business aircraft need to be able to fly to any airport in the national air transportation system. Any degradation of that capability is a reason not to utilize business aviation.

"The question going forward is, 'Will the world be better tomorrow in terms of access to airports and airspace, or will it get worse?'" said Ed Bolen, president of the General Aviation Manufacturers Association, whose member companies build most of the business aircraft flying today. "That is the question that keeps all of us in Washington [aviation organizations] up at night. Access to airports and airspace is probably the biggest issue facing our industry."

Some are optimistic that the problem can be solved soon. NBAA President Shelley A. Longmuir said, "There has to be a way to address the federal government's concerns about security while recognizing the contribution that business operators, their corporations and employees make. There is far more in the way of security measures that these operators have taken that perhaps is not known or appreciated. Our role at the NBAA is to help the federal government become aware of what our members already do. I am optimistic that what we are already doing will be of great comfort to them [regulators]."

The NBAA is willing to do even more. Association officials have proposed that the TSA issue Access Certificates (TSAACs) to corporate operators that follow government-approved security protocols. These certificates would give users the right to fly in certain restricted airspace the way the airlines do. Under a pilot program being conducted by NBAA, 10 operators have completed the training needed to qualify for a TSAAC. NBAA officials hope that the program will go national by the end of the year.

Meanwhile, sales of business aircraft seem poised for a turnaround. "No one is ready to say that the recovery has



gun, but I think most people feel things are not getting worse," said Bolen, who suggested that today's higher utilization will hasten the need for replacement aircraft.

Also, the pending requirement that airplanes be retrofitted with more-precise navigation equipment will force the retirement of older business aircraft for which the expensive modifications would be hard to rationalize. Finally, recently enacted tax benefits are encouraging some to buy new aircraft. However, an economic recovery will be the principal reason aircraft sales rebound.

In the meantime, manufacturers continue to invest in new technologies. Dassault's latest business jet, the 7X, will be the first one in the world with fly-by-wire flight controls, which will improve safety and passenger comfort. Bill Kerneve, Dassault's chief pilot, said, "There is no better way to give a pilot total mastery over his airplane. Fly-by-wire holds a level of flight control that can't be matched by mechanical means."

Bombardier also is developing new airplanes. "With six new products entering into service within the next two years...we are committed to offering a variety of air transportation solutions to all aviation users, whatever their needs. Even in these challenging times, we are present with

innovative products, demonstrating our resolve to maintain our strong market position," stated Pierre Beaudoin, president and CEO of Bombardier Aerospace.

"As other forms of travel become more challenging, they become the biggest advertisement for business aviation," said NBAA's Longmuir. "Our members are giving [their passengers precious] time in a secure, sterile airplane to conduct sensitive negotiations or do confidential work—to essentially have a flying office. That is almost impossible to replicate [on any other form of transportation]."

"The future looks pretty bright because, as countries become more affluent, people desire and demand mobility, and mobility is best served by general aviation," asserted Bolen. "But that is based upon the premise that you will be able to fly where you want to, when you want to," he cautioned. "The challenge for all of us who are responsible for aviation policy here in Washington is to make sure that promise is valid." ♦

Written By: Robert A. Searles • Designed By: Dale A. Serena

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THE NEXT STEP IN COCKPIT TECHNOLOGY

Computers have been used in aircraft cockpits for years, but Dassault is taking the sophisticated flight deck further by developing a fully integrated flight management system called EASy (enhanced avionics system). A Dassault version of Honeywell's new-generation Primus Epic avionics system, EASy promises to reduce pilots' workload while improving their situational awareness through the use of an intuitive and interactive man-machine interface.

Dassault has created a patent-

ed cursor control device (CCD) that enables Falcon pilots to open, close and select items that are depicted on four large, flat-panel color screens in the cockpit. Virtually all the data needed to operate the airplane is stored in the computer.

With the CCD, pilots can perform functions without diverting their eyes from the instrument panel, as would be required when using older-style keyboards. The result is more head-up time and, thus, a safer cockpit.

EASy's graphically oriented

management system improves the speed and accuracy of performing many functions. For example, a pilot can simply click on an icon depicting the phase of flight to bring up the associated menus. And the menus themselves are intelligent; as soon as a data field is filled, the cursor goes directly to the next item. The checklists even have an auto-sensing function that makes tasks pop up automatically when

required and close once the tasks are completed.

The EASy system has already flown on Dassault's Falcon 900EX



Dassault's EASy cockpit is among the most modern aircraft instrument panels.



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Web Searches: The Fix Is In

How much exposure can you buy?
Plenty, concludes a *BusinessWeek* probe

THEY'RE CALLED SPIDERS. Scores of these digital robots crawl through cyberspace, scouring the billions of pages in the World Wide Web. They catalog all the words in the pages, how many times they're viewed, and which other pages they link to. These spiders power the fast-growing search industry, led by Google, Yahoo!, and Mi-

crosoft's MSN. This is quickly becoming humanity's favorite tool for finding out just about anything, with 550 million Internet searches performed worldwide each day. Type in a couple words, say "sleeping" and "bag," and the engine, fueled by its spiders and scientific algorithms, promptly provide a list of Web sites, starting with the most relevant. Right?

Not so fast. In the last year, a host of

search engines, including MSN and Lycos, have sprinkled growing numbers of paid corporate Web pages into the search results and accepting money each time one of these so-called paid-inclusion links is clicked. This practice is a booming business, one expected to double this year, to \$200 million, and to reach \$600 million by 2007, says U.S. Bancorp Piper Jaffray. But unlike the clearly marked advertised links that show up next to search results, these paid inclusions are virtually invisible to average Web surfers. Only specialists prepared to decipher Web addresses can begin to distinguish between the paid and unpaid pages. "These are not objective oracles of information," says Beau Brendler, director of Consumer WebWatch, a project of Consumers Union.

Controversy over paid inclusion is driving a wedge through the search industry. At the heart of the issue is whether the industry's content will be swayed by advertisers. Google, the leading search engine, steers clear of paid inclusions, saying that they undermine confidence in the objectivity of search results. Instead, Google relies entirely

The cost of "paid inclusion" is a threat to small fry

upon its technology for the search, and features paid ads only in clearly marked boxes near the search results. AOL uses Google technology and follows the same line. But others, including Yahoo, say that paid inclusion can provide users with better information.

And they maintain that their search results are still displayed in order of relevance. That means that paid ads get no preferential treatment. "All listings are run through an algorithm that is blind to their source," says Tony Mamone, sales vice-president at LookSmart Ltd., which feeds paid-inclusion results to portals like MSN.

TICKET TO THE TOP

YET AN INVESTIGATION by *BusinessWeek*, based on more than 30 interviews and analysis of dozens of Internet searches, suggests that paying customers frequently fare better. Indeed, out of 20 advertisers and online marketing pros interviewed by *BusinessWeek*, 10 had experienced firsthand a boost in search-engine rankings when they



TRAFFIC IS DOWN
Spooner's site suffered after he said no to Inktomi

What's In Your **Search Results?**

Some **search engines** use an approach called "paid inclusion" that mixes computer search results with listings that have been paid for—without disclosing which is which.

PURE SEARCH

- Search engines have built an index by scouring billions of Web pages. It lists pages from its index based on myriad criteria like the number of other sites that link to the page.
- Results are ranked by the highest scores against the criteria, with results fluctuating day by day.
- No money changes hands between the search engine and the sites that are listed or visited.

PAID PLACEMENT

- Most search engines have advertisers who bid against each other to be displayed for a phrase, such as "sleeping bag."
- Paid placement results appear near the unpaid search results. They are typically marked as "sponsored links" and often shaded a different color.
- For every click on a paid-placement listing, the sleeping-bag site pays the search engine a fee, from a dime to \$10.

PAID INCLUSION

- Companies with thousands of products often pay to channel their sites directly to search engines.
- Search companies say the paid pages compete fairly, with pure search listings. But *BusinessWeek* analysis shows that these paid pages sometimes rise to the top of the search results.
- If a Web surfer clicks on a site that paid for inclusion, the site owner pays the search company between 15¢ and 75¢.

signed up for paid inclusion. Says James Taylor, CEO of AICompany.com, a search-marketing company, "Paid inclusion dilutes the accuracy and relevance of a search engine."

Dennis Swanson learned the hard way. Earlier this year, the chief executive of Lamps Plus Inc., couldn't understand why his e-commerce offerings for light fixtures turned up so prominently in Google but were nearly out of sight on MSN. So he paid to have his site included with LookSmart, which feeds search results to MSN and shares with MSN revenues it gets from advertisers. Almost instantly, Lamps Plus pages soared to near the top of MSN's search results, and Microsoft's portal became Swanson's biggest traffic driver. When he temporarily stopped his LookSmart deal, MSN's traffic spigot shut off. "If we don't have a deal with LookSmart, we don't show up in MSN's results," he says. MSN, while declining to comment on this case, says it is currently reevaluating its entire Internet search offering, including paid-inclusion listings, to put forth the most relevant results.

HITS AND MISSES

WHAT GIVES? FOR STARTERS, the paid-inclusion pages are easily engineered for high placement. When submitting paid-inclusion data, companies typically fill out a spreadsheet with information on product details, along with the search words and phrases for which they'd like to appear. The result is a rich stream of data targeted precisely to what the search engine will deem relevant. Conse-

quently, their ratings are primed to soar.

Anecdotal examples aren't tough to turn up. Plug in "green sleeping bag" to HotBot.com and the first six results, in a recent search, featured paid-inclusion listings from Inktomi, which is now owned by Yahoo. Some weren't even for sleeping bags. The fifth listing took users to a paid-inclusion product page for a white canvas bag. Meanwhile, numerous pure results displayed lower were highly relevant product pages for green sleeping bags. A Yahoo spokesperson responds that there are just as many examples of paid-inclusion listings improving search results.

Despite criticisms, the paid-inclusion business addresses some very real needs. One biggie is the sheer number of Web pages tucked away in corporate databases, where search-engine spiders have a difficult time navigating. By letting, say, Staples.com pipe its data directly to a search engine, a user seeking "inkjet cartridges" could get a fresh listing from Staples.com that might not otherwise show up. "We use [paid inclusion] only if it's improving the relevance of our results," says Tim Cadogan, Yahoo's vice-president for search.

Still, the growth of paid inclusion could tilt the search business toward deep-pocketed companies. For instance, travel sites that want to be in LookSmart's paid-inclusion program have to pay the company a flat rate of 30¢ for each click,

according to the company's Web site. Jur chains like Marriott International Inc. or Hilton Hotels Corp. are certainly better equipped to cover search costs than, say, a bed-and-breakfast.

Just ask Rob Spooner. The 56-year-old run-travel site called OnHighways with informational pages about various small towns throughout the U.S. Inktomi, a search engine that now belongs to Yahoo, contacted him last year about becoming a paid-inclusion participant. The proposal: Spooner would pay 10¢ for every visitor Inktomi passed along. Spooner did the math, figured he would

lose money on anything more than 30 clicks, and declined the offer.

Then things went downhill. Spooner's Web pages soon plunged in Inktomi search rankings and disappeared from key sites like MSN, where Inktomi feeds its listings. After he demanded to know what happened, Spooner learned from Inktomi that his site contained editorial flaws that hurt his ranking. And he would have to become a paid-inclusion customer to learn what the flaws were. All this, while his pages remained well ranked on Google. "I lost a quarter of my traffic," says Spooner.

Yahoo declined to comment on this incident. However, it and other search engines offering paid inclusion say it serves the customers' interests. Says Tom Wilde, general manager of search services

at Terra Lycos: "If you deliver a poor user experience, people leave, and they leave rapidly."

And why not label the sponsored links? Many search companies and advertisers fret that marking them would scare the public away from relevant sites. Says Glenn McLaren, e-commerce manager at Friedrich Air Conditioning: "Part of what makes it attractive is that it doesn't look like advertising." The trouble is, if paid inclusions are hidden, readers could grow to dismiss Internet search as nothing but a pile of ads. ■

—By Ben Elgin in San Mateo, Ca



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COMMENTARY

BY CATHERINE YANG

Wireless: Answer the Call

New FCC rules could really expand cell-phone use—if carriers play it right

In just two months, cell-phone carriers warn, the world of wireless could turn into pandemonium. Why? The Federal Communications Commission is expected to require service providers, starting on Nov. 24, to allow customers to take their phone numbers with them when they switch to another carrier. The fixed number was one of the few tools the companies had to retain customers. Now, the industry, already battered by competition, is girding for a free-for-all. "When one-third of subscribers already change carriers every year, you don't need this to spur competition," frets Tom Wheeler, president of the Cellular Telecommunications & Internet Assn. (CTIA).

No doubt the carriers will take a hit. But instead of agonizing over the extra competition, the cellular companies should follow the lead of Verizon Wireless and embrace the new rules as an opportunity. The pain could pay off if the change spurs carriers to fix deep problems.

Think of wireless as a moody teen, a powerful lunk brimming with potential—but hardly reliable. Like that adolescent, consumers need to be able to count on this industry before users will be willing to trust it with important jobs. Half of all cell-phone users are dissatisfied, grouching about everything from network dependability and sound quality to phone selection, according to a Forrester Research Inc. survey done last year. If it can remedy those problems, wireless can enter the same league with regular phones or electric lights. Here's how:

SWITCHING. Today, 3.5% of U.S. households have abandoned

their landline phones and rely solely on cellular—vs. 5% of Western Europeans, says Forrester Research. The U.S. industry could speed the ascent of wireless—and enjoy the resulting surge in cellular usage—by pushing the feds to require the Baby Bells to let consumers take their landline phone numbers with them when they go completely wireless. The U.S. Telecom Assn., a local phone lobbying group, says it accepts the idea, mandated by the Telecommunications Act of 1996, but warns it will be extremely difficult to implement.

WHITE PAGES. Cellular operators have resisted offering a directory of wireless users' numbers for fear that competitors could call and poach their customers. But now, the CTIA is urging them to pool the numbers into one database, to be run by a third-party company. Only subscribers who consent will have their numbers listed. With adequate safeguards, directory assistance would make wireless calling more mainstream, and increase usage.

NETWORK UPGRADES. Capital investment by wireless carriers usually pays off. High-spending Verizon now leads the industry.

It would take anywhere from \$50 billion to \$100 billion to bring U.S. wireless infrastructure up to snuff, the Yankee Group says. While not every carrier can undertake the hefty investments, if coverage holes overnight, they can come clean about weak spots with detailed maps showing where phones will or won't work. Congress and the California Public Utility Commission may even require wireless carriers to make fuller disclosures about reliability just as ice cream makers are forced to disclose the number of grams of fat in a scoop of vanilla swirl.

And who knows? If those reliability numbers get good enough, maybe companies will start advertising them. That's when we'll know that the cell-phone industry has arrived. ■

With Roger O. Crockett in Chicago



A CELLULAR TO-DO LIST

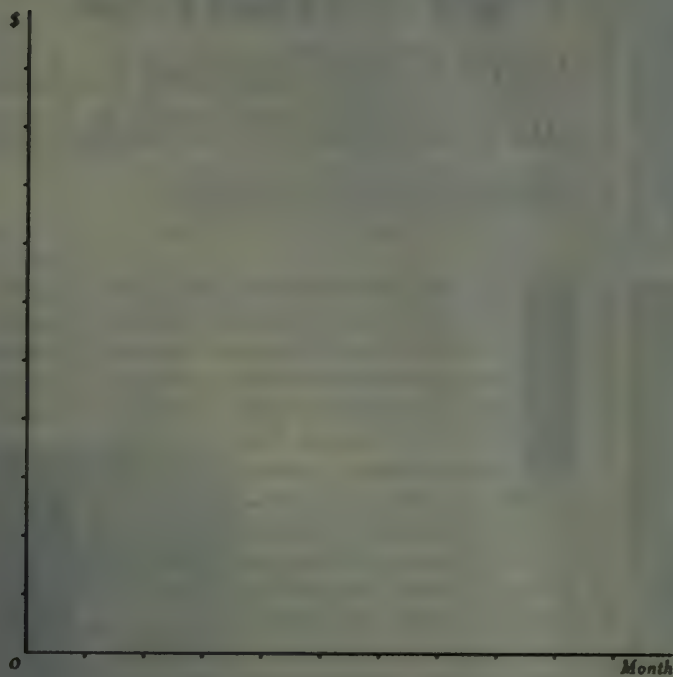
Mobile phones are hugely popular, yet half of U.S. users complain about their service. Here's how to fix it:

1 PORTABLE PHONE NUMBERS Carriers should stop fighting an expected Nov. 24 rule that will allow consumers to keep their numbers when they switch carriers. In the long haul, it will boost usage.

2 DIRECTORY ASSISTANCE Allowing callers to look up mobile phone numbers in a central data base will promote cell phone use.

3 NETWORK CAPACITY Up capital spending to stamp out poor coverage and dropped calls, and achieve greater reliability.

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Parsons Goes For Plan B

With Time Warner Cable's IPO on hold, the CEO is finding new ways to raise cash

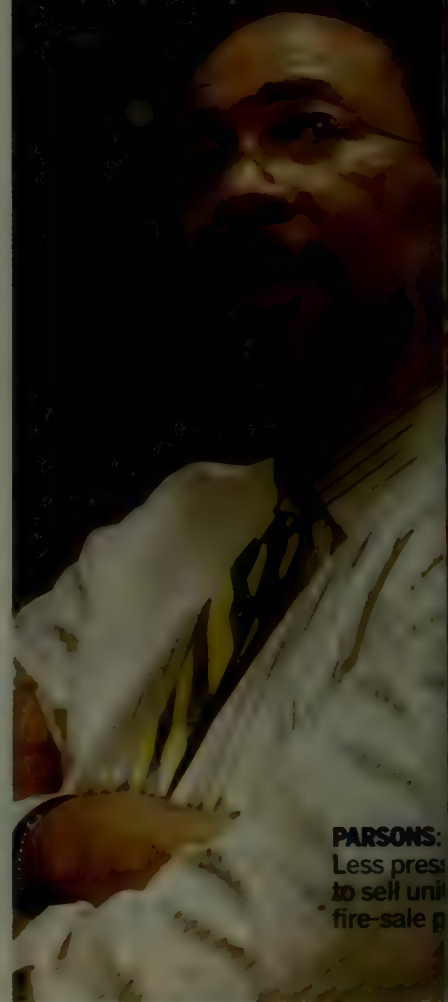
IN THE COMING WEEKS, THE AOL of AOL Time Warner Inc. will be stripped from building facades, corporate letterheads, and eventually Wall Street tickers. Make no mistake, though: Even with the name change, approved on Sept. 18, America Online's woes still pervade the world's largest media company.

Nobody is feeling this more than execs at Time Warner Cable, who had hoped by yearend to have reached two goals: to be trading as a separate company and to have helped the parent company pay down billions in debt from the stock sale. For nearly nine months, cable execs have been in a quiet period in anticipation of a partial initial public offering. Now it appears the restraint was all for nothing: Execs at headquarters recently shelved the IPO, doubtful of Securities & Exchange Commission approval to register the shares as long as regulators were still burrowed in their investigation of aggressive accounting at the online unit.

The IPO postponement is clearly a setback for the nation's No. 2 cable operator. But it's also a blow to Time Warner CEO Richard D. Parsons' original plan to shore up the balance sheet, testing his agility to find new ways to raise cash. Trading separately at a time of rising cable stock prices would have given Time Warner Cable its own currency to make acquisitions. In the past year, competition between cable and satellite has intensified, and the unit could use added heft in the shadow of Comcast, the industry's new goliath. More important, the cable IPO could have raised as much as \$2 billion in cash. While the Time Warner CEO has slashed more than \$5 billion from nearly \$30 billion in debt since January, he had been counting on a robust cable offering. After all, besides the accounting investigation, Parsons' second-

biggest challenge is showing Wall Street he can quickly erase debt. Until he resolves both, Time Warner's shares, languishing at \$16, aren't likely to be useful as deal currency for any of the units.

A lighter debt load?



PARSONS: Less pressure to sell unit in fire-sale price

CHARLES OMMANNEY/CONTACT

hellomoto.com



but thanks to some surprises, such as a \$10 million settlement from Microsoft in May, Parsons admits some of the pressure is off to sell pieces of the company. At the moment, he's ahead of goal to reduce debt to \$20 billion by end of 2004 (table). "We've had some successes that obviate the need now for an IPO," says Parsons.

As a result, the CEO is reshaping his plan. Sales of assets once considered disposable, such as Warner Books Inc., are held until better offers arrive. And assets that were said to be core, such as recorded music and music publishing, are mentioned as possible sell-offs. "We always felt music was in need of restructuring," says Parsons. "When you produce music in 70 countries, you need to ration overhead to strengthen the business, particularly against the winds of piracy." Warner/Chappell Music Inc., which controls 1 million copyrights, could garner more than \$1 billion. And execs will create

either a joint venture for Warner Music Group or sell a majority of it. A deal with London's EMI Group PLC, for example, could raise \$1 billion upfront.

"BIG ENOUGH"

WITH THE CABLE UNIT no longer critical to Parsons' debt goal, its execs, under wraps for so long, can now openly push their products in the changed cable arena. With 10.9 million subscribers, Time Warner runs a distant second to Comcast, with 21 million. Clearly, scale can make it easier for operators to negotiate favorable equipment and programming prices—crucial savings as companies face stiffer competition. But Time Warner Cable CEO Glenn A. Britt says doing deals is less important than selling new services, such as video-on-demand, high-definition TV, and personal video-recorder options. "I'm not worried about our size," says Britt. "We are big enough to support our technological overhead."

Without an IPO, CEO Dick Parsons' plan to slash debt to \$20 billion by the end of 2004 appears to be on track.

WHERE NEW CASH IS COMING FROM

50% of Comedy Central	\$1.25 BIL
Soft settlement	0.75
General Motors-Hughes shares	0.80
CD-manufacturing unit	1.10
Atlanta Hawks, Thrashers	0.25
Cash flow, 2003 estimate	2.75

WHAT'S PUT ON HOLD

Book Publishing	\$0.33
Warner Cable IPO	2.0
Braves	0.35 TO 0.40

WHERE MORE CASH COULD COME FROM

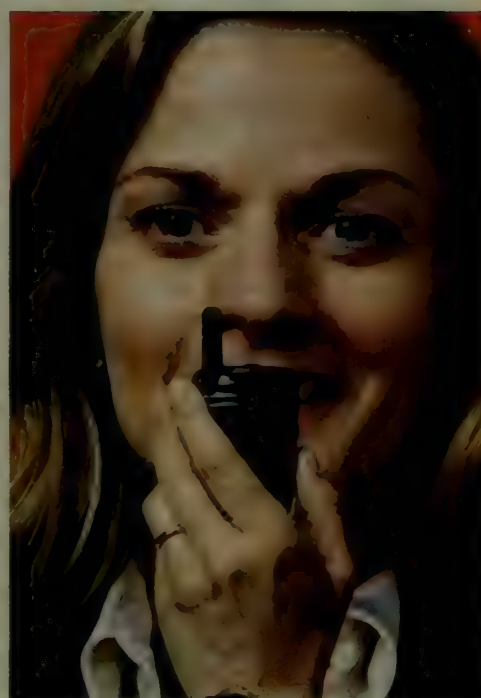
Warner/Chappell music-publishing unit	\$1.1
Profit front in merger of Warner Music Group with BMG	0.15
Profit from sale of part of WMG to EMI	1.0
Debt at yearend 2002	\$25.7 BIL
Debt	\$4.1
Debt	\$29.8 BIL
Net cash raised and potential cash in best-case scenario	-9.0
	\$20.8 BIL

Synch & Co., BusinessWeek

IPO or no, prospects for the \$7.7 billion cable division are still bright, say investors. Its earnings this year will account for about one-third of the parent's overall \$9.2 billion in earnings before interest, taxes, depreciation and amortization (EBITDA), estimates Morgan Stanley. And a roll-out of new services has begun. By yearend, Time Warner Cable will be ahead of any other operator, with nearly half a million subscribers to a personal video-recorder service (similar to TiVo Inc.), and could have as many as 1 million phone subscribers by 2006. Next year, cable will generate an estimated \$860 million in free cash flow.

Parsons will certainly welcome the contribution to his debt-reducing mission, especially since there is no predicting when AOL's bad karma might strike again. The company faces more than 30 shareholder lawsuits, stemming mostly from AOL's problems, and uncertain sums in settlements. Parsons can use all the cash he can get his hands on.

By Tom Lowry
in New York



motorola V60p



MOTOROLA
V60p



Did the Bengals Claw Taxpayers?

A local official is suing the team over the financing of Paul Brown Stadium

IF THE DALLAS COWBOYS ARE America's Team, the Bengals are Cincinnati's Torment. This year's 0-3 start prolongs the misery for Bengals fans, who last season endured a franchise-worst 2-14 record. Even the good old days were lousy: In the '90s, the Bengals had the worst record in pro football.

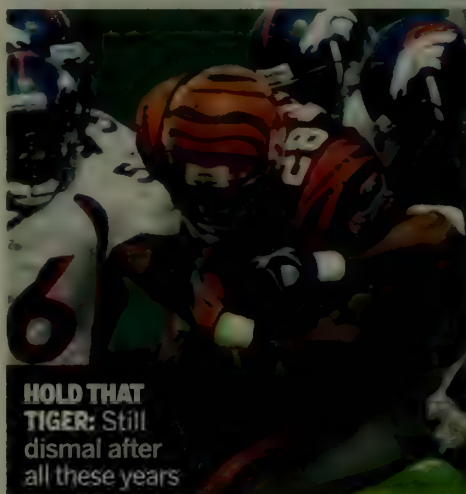
The only victory the team has had this season came in a courtroom. On Sept. 5, a judge in Hamilton County dismissed a lawsuit alleging, among other things, that the Bengals committed fraud in duping county taxpayers into footing the bill for three-year-old Paul Brown Stadium. The suit claimed that the franchise compounded its deceit when management failed to make minimal efforts to field a competitive team. "People here are beginning to differentiate between rooting for the players and feeling used by management," says Todd Portune, the Hamilton County commissioner who filed the suit as an individual taxpayer.

Paul Brown Stadium opened in 2000 after years of friendly persuasion and arm-twisting. Team management began its campaign in the early '90s, claiming that new revenue from a gleaming pigskin palace was the only way for the team to remain viable. There were also veiled threats to move up the road to Baltimore. Hamilton County taxpayers approved a half-penny sales tax to finance the \$458 million stadium in March, 1996.

In a city where dislike of Bengals owner Mike Brown runs deep because of years of losing and disastrous public relations, the ruling for the team hardly ends the matter. Portune filed an appeal that day. And a federal lawsuit also brought by Portune against the team and the National Football League on

antitrust grounds is awaiting a hearing.

The double-barreled legal action is an extreme example of local anger at a pro sports franchise that corralled hundreds of millions in public money for a new stadium. Indeed, the stadium deal is at the core of the dispute between the Bengals and Portune, the lone Democrat on the three-member county commission that negoti-



HOLD THAT TIGER: Still dismal after all these years

Crying Poverty

The Bengals were making millions when they sought public money for a new stadium

YEAR	PROFITS MILLIONS	RANK IN NFL*
1995	\$10.3	10
1996	10.9	8
1997	12.2	9
1998	14.4	14
1999	8.6	18

*Among 30 teams, 31 in 1999

Data: Records disclosed during a 2001 lawsuit filed by Oakland Raiders owner Al Davis against the NFL

ated the lease for the facility. (He decided to file suit alone when his colleagues voted against suing the team.) But another factor is exasperation with Brown, 68, the soon-to-be exalted team founder and Hall of Fame coach Paul Brown. "We're the butt of an NFL joke. How would that make you feel?" says Portune.

Since the elder Brown's death in 1986, Mike, a Harvard law grad, has shown none of his father's genius for assembling a winning team. He has made most decisions himself, only this year delegating more authority to highly regarded coach Marvin Lewis. From 1994 to 2000, the Bengals spent less on player salaries than all but two franchises. "To Mike, there's no science to putting together a team. He sees players as interchangeable drill bits," says Bob Trumpy, an NFL radio analyst and Bengals receiver from 1970 to 1977. Brown declined to comment on this story.

FOLLOW THE MONEY

IN ONE CATEGORY, however, the owner has performed like an All-Pro: counting cash. From 1995 to 1999, the Bengals four times racked up annual profits of \$10 million or more, according to financial documents disclosed in 2001 during litigation filed by Oakland Raiders owner Al Davis against the NFL. In 1999, when the team managed an 8-8 record, Brown & Co. ended the season with nearly \$11 million profit, eighth-highest in the NFL.

Portune vividly recalls reading the figures and flashing back to his months listening to Brown and other Bengal officials warn that the team couldn't stay competitive unless taxpayers footed the bill for its home field. "It was a jaw-dropper," he recalls.

The disclosures set in motion the litigation that some see as political theater but that Portune defends as payback for the Bengals' iniquity. "I don't relish [lawsuits]. I think they're absolutely necessary given the way the community was taken to the cleaners," he says. Legal experts say the antitrust claims may have the best chance, since the league could be found liable if it used its monopoly power to threaten a city with the loss of a team it didn't pony up.

Jeffrey Pash, the NFL's lawyer, naturally believes the suits have no merit. "At the end of the day, I don't think there'll be a finding of wrongdoing," he says. Either way, taxpayers in Bengals country may have passed the collection plate for the last time. ■

By Mark Hymowitz



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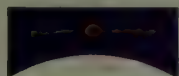
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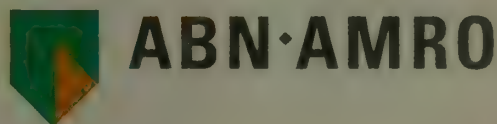
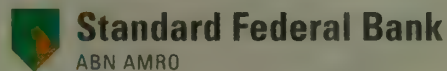
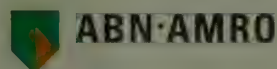


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Low prices are great. But Wal-Mart's dominance creates problems—for suppliers, workers, communities, and even American culture.

**BY ANTHONY BIANCO
AND WENDY ZELLNER**

POWER



S WAL-MART TOO
REFUL?

IN BUSINESS, THERE IS BIG, AND THERE is Wal-Mart. With \$245 billion in revenues in 2002, Wal-Mart Stores Inc. is the world's largest company. It is three times the size of the No.2 retailer, France's Carrefour. Every week, 138 million shoppers visit Wal-Mart's 4,750 stores; last year, 82% of American households made at least one purchase at Wal-Mart. "There's nothing like Wal-Mart," says Ira Kalish, global director of Deloitte Research. "They are so much bigger than any retailer has ever been that it's not possible to compare."

At Wal-Mart, "everyday low prices" is more than a slogan; it is the fundamental tenet of a cult masquerading as a company. Over the years, Wal-Mart has relentlessly wrung tens of billions of dollars in cost efficiencies out of the retail supply chain, passing the larger part of the savings along to shoppers as bargain prices. New England Consulting estimates that Wal-Mart saved its U.S. customers \$20 billion last year alone. Factor in the price cuts other retailers must make to compete, and the total annual savings approach \$100 billion. It's no wonder that economists refer to a broad "Wal-Mart effect" that has suppressed inflation and rippled productivity gains through the economy year after year.

However, Wal-Mart's seemingly simple and virtuous business model is fraught with complications and perverse consequences. To cite a particularly noteworthy one, this staunchly anti-union company, America's largest private employer, is widely blamed for the sorry state of retail wages in America. On average, Wal-Mart sales clerks—"associates" in company parlance—pulled in \$8.23 an hour, or \$13,861 a year, in 2001, according to documents filed in a lawsuit pending against the company. At the time, the federal poverty line for a family of three was \$14,630. Wal-Mart insists that it pays competitively, citing a privately commissioned survey that found that it "meets or exceeds" the total remuneration paid by rival retailers in 50 U.S. markets. "This is a good place to work," says Coleman H. Peterson, executive vice-president for personnel, citing an employee turnover rate that has fallen below 45% from 70% in 1999.

Critics counter that this is evidence not of improving morale but of a lack of employment alternatives in a slow-growth economy. "It's a ticking time bomb," says an executive at one big Wal-

Mart supplier. "At some point, do the people stand up and revolt?" Indeed, the company now faces a revolt of sorts in the form of nearly 40 lawsuits charging it with forcing employees to work overtime without pay and a sex-discrimination case that could rank as the largest civil rights class action ever. On Sept. 24, a federal judge in California began considering a plaintiff's petition to include all women who have worked at Wal-Mart since 1998—1.6 million all told—in a suit alleging that Wal-Mart systematically denies women equal pay and opportunities for promotion. Wal-Mart is vigorously contesting all of these suits.

Wal-Mart might well be both America's most admired and most hated company. "The world has never known a company with such ambition, capability, and momentum," marvels a Boston Consulting Group report. On Wall Street, Wal-Mart trades at a premium to most every other retailer. But the massive size and power that "the Beast of Bentonville" amasses, together with the greater backlash it is stirring among competing retailers, vendors, organized labor, community activists, and cultural and political progressives. America has a long history of controversy over big retailers, notes James E. Hoopes, a history professor at Boston College. "What's new about Wal-Mart is the flak it's drawing from outside the world of its competition," he says. "It's become a social phenomenon that people resent and fear."

Wal-Mart's marketplace clout is hard to overstate. In household staples such as toothpaste, shampoo, and paper towels,



WELCOME TO L.A. The company recently opened an inner-city store near Watts

Wal-Mart controls a large and rapidly increasing share of business done by most every major U.S. consumer-products company: 28% of Dial's total sales, 24% of Del Monte Foods', 23% of Clorox', 23% of Revlon's, and on down the list. Suppliers' growing dependence on Wal-Mart is "a huge issue" not only for manufacturers but also for the U.S. economy, says Tom Rubel, CEO consultant Retail Forward Inc. "If [Wal-Mart] ever stumbled, we've got a potential national security problem on our hands. They touch almost everything....If they ever really went into tailspin, the dislocation would be significant and traumatic."

Even so, Wal-Mart appears to be in no imminent danger of running afoul of federal antitrust statutes. The Robinson-Pattman Act of 1936 was passed in large part to protect mom-and-pop grocers from the Great Atlantic & Pacific Tea Co., the W-

the company commands about 30% of the U.S. market, and analysts predict that its share of many such goods could hit 50% before decade's end. Wal-Mart also is Hollywood's biggest outlet, accounting for 15% to 20% of all sales of CDs, videos, and DVDs. The mega-retailer did not add magazines to its roster until the mid-1990s, but now makes 15% of all single-copy sales in the U.S. In books, too, Wal-Mart has quickly become a force. "They pile up best sellers like toothpaste," says Stephen Riggio, chairman of Barnes & Noble Inc., the world's largest bookseller.



PACKING HEAT Some Wal-Marts ban **gun sales**. But not in Texas

The Long Arm of Bentonville, Ark.

For better or worse, Wal-Mart is one of the most powerful companies in history. Here's how it flexes its muscles:

- THE WAL-MART ECONOMY**

It's the largest company in the world, with \$245 billion in sales last year. McKinsey estimates that an eighth of the productivity gains in the late '90s came from Wal-Mart's drive for efficiency, and the discounter has been at least partly responsible for the extraordinarily low inflation rate of recent years. Its \$12 billion in imports from China last year accounted for a tenth of total U.S. imports from that nation.
- POWERING WAGES**

With a global workforce of 1.4 million, Wal-Mart plays a huge role in wages and working conditions worldwide. Its hard line on costs has forced many factories to move overseas. Its labor costs are 20% less than those at unionized supermarkets. In 2001, its sales clerks made less, on average, than the federal poverty level.
- DISRUPTING COMMUNITIES**

Wal-Mart's huge advantages in buying power and efficiency force many local rivals to close. For every Wal-Mart supercenter that opens in the next five years, two other supermarkets will close. And because the chain often extracts tax breaks, some economists believe that Wal-Mart's entry into a community doesn't result in any net increase in jobs and tax revenue.
- POLICING THE CULTURE**

In the name of protecting customers, Wal-Mart has forced magazines to hide covers it considers racy and has booted others off its racks entirely. It won't carry music or computer games with mature ratings. Record companies sell Wal-Mart sanitized versions of CDs. Elsewhere in the store, the chain declines to sell Preven, a morning-after pill. Most locations do offer inexpensive firearms.
- DOMINATING SUPPLIERS**

In its relentless drive for lower prices, Wal-Mart homes in on every aspect of a supplier's operation—which products get developed, what they're made of, how to price them. It demands that every savings be passed on to consumers. No wonder one consultant says the second-worst thing a manufacturer can do is sign a contract with Wal-Mart. The worst? Not sign one.

Wal-Mart's U.S. market share of consumer staples could hit 50% by the decade's end

Mart of its day. But contemporary antitrust interpretations eschew such David-and-Goliath populism. Giants like Wal-Mart have wide latitude to do as they wish to rivals and suppliers so long as they deliver lower prices to consumers. "When Wal-Mart comes in and people desert downtown because they like the selection and the low prices, it's hard for people in the antitrust community to say we should not let them do that," says New York University law professor Harry First.

CEO H. Lee Scott Jr. and other Wal-Mart executives are aware of the rising hostility the company faces and are trying to smooth its rough edges in dealing with the outside world. But they have no intention of tampering with its shopper-centric business model. "We don't turn a deaf ear to any criticism. We're most sensitive to what the customer has to say, though," says Vice-Chairman Thomas M. Coughlin. "Your customers will tell you when you're wrong."

Wal-Mart cites customer preferences as the reason it does not stock CDs or DVDs with parental warning stickers and why it occasionally yanks items from its shelves. In May, it removed the racy "lad" magazines *Maxim*, *Stuff*, and *FHM*. A month later, it began obscuring the covers of *Glamour*, *Redbook*, *Marie Claire*, and *Cosmopolitan* with binders. Why did Wal-Mart censor these publications and not *Rolling Stone*, which has featured a nearly naked Britney Spears and Christina Aguilera on two of its recent covers? "There's a lot of subjectivity," concedes Gary Severson, a Wal-Mart general merchandise manager. "There's a line between provocative and pornographic. I don't know exactly where it is."

Wal-Mart was the only one of the top 10 drug chains to refuse to stock *Preven* when Gynetics Inc. introduced the morning-after con-

traceptive in 1999. Roderick L. Mackenzie, Gynetics' founder and nonexecutive chairman, says senior Wal-Mart executives told his employees that they did not want their pharmacists grappling with the "moral dilemma" of abortion. Mackenzie was censored but tried to hide it. "When you speak to God in Bostonville, you speak in hushed tones," says Mackenzie, who plained, to no avail, that *Preven* did not induce abortion rather prevented pregnancy. Wal-Mart spokesman Jay A. says "a number of factors were considered" in making the *Preven* decision, but he denies that opposition to abortion was of them. "If anybody of any belief reads any moral decision [into] that, that's not right," he says.

EXTRA LARGE Wal-Mart has a **79%** share of the U.S. supercenter market.

King Kong in Diapers

WAL-MART dominates sales in a number of categories:

Disposable diapers

32%

Hair care

30%

Toothpaste

26%

Pet food

20%

Home textiles

13%

U.S. market share based on 2002 data from Nielsen Retail Forward, Home Textiles Today.



CULTURAL GATEKEEPER

THERE IS NO QUESTION THAT the company has the right to sell only what it chooses to sell, even in the case of First Amendment-protected material such as magazines. By most counts, though, Wal-Mart's cultural gatekeeping has served narrow the mainstream for entertainment offerings while imparting to it a rightward tilt. The big music companies have stopped grousing about Wal-Mart and are eagerly supplying the chain with the same sanitized versions of explicit CDs that they provide to radio stations. "You can't have 100% impact when you are taking an artist to a mainstream audience if you don't have the biggest player, Wal-Mart," says EMI Music North America's



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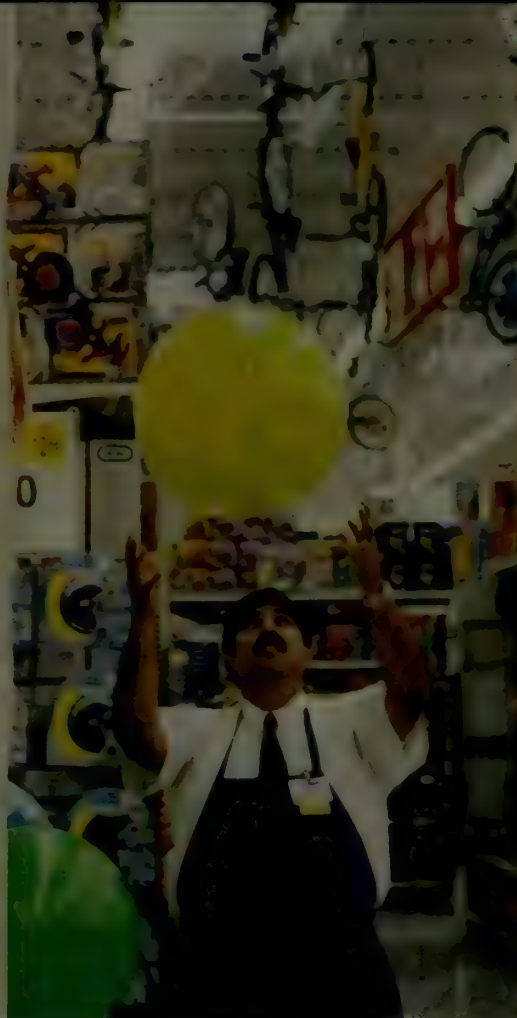
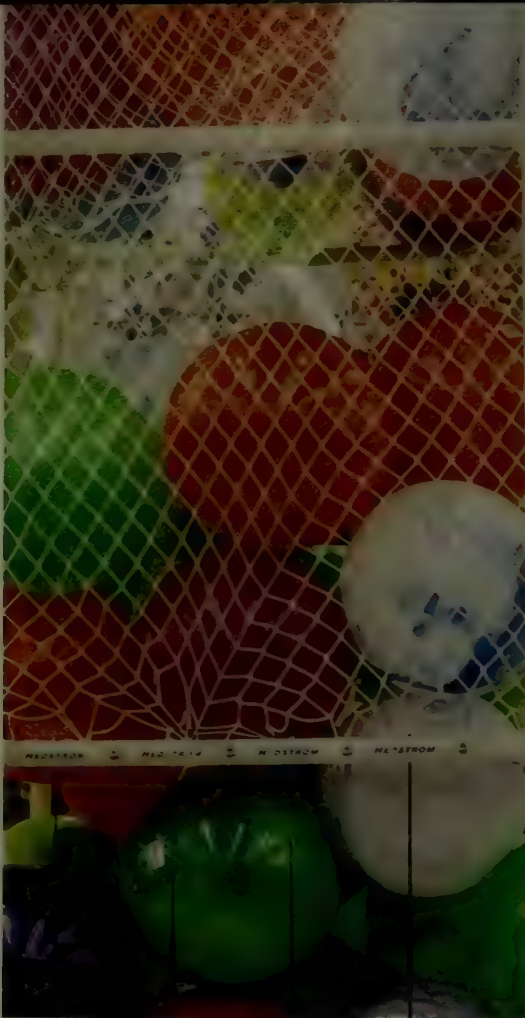
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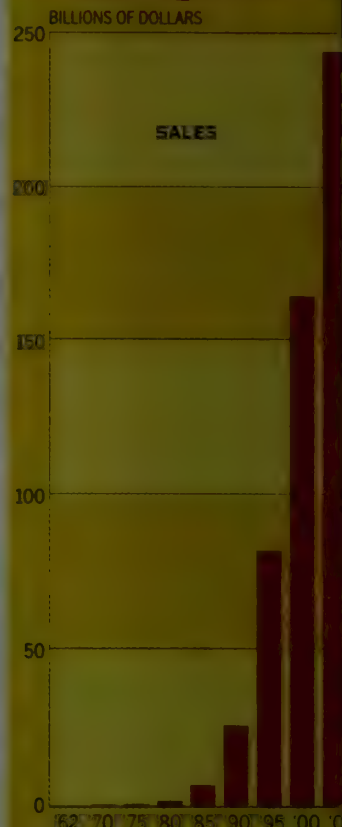
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41 Years of Nonstop Growth



FIGURES REFLECT FISCAL YEARS ENDING IN JANUARY
Data: Wal-Mart Stores Inc.

ROUND FIGURES

Wal-Mart denies that its wages are **substandard**

America Executive Vice-President Phil Quartararo.

This year alone, Wal-Mart hopes to open as many as 335 new stores in the U.S.: 55 discount stores, 210 supercenters, 45 Sam's Clubs, and 25 Neighborhood markets. An additional 130 new stores are on the boards for foreign markets. Wal-Mart currently operates 1,309 stores in 10 countries, ranking as the largest retailer in Mexico and Canada. If the company can maintain its current 15% growth rate, it will double its revenues over the next five years and top \$600 billion in 2011.

That's a very big if—even for Wal-Mart. Vice-Chairman Coughlin's biggest worry is finding enough warm bodies to staff all those new stores. By Wal-Mart's own estimate, about 44% of its 1.4 million employees will leave in 2003, meaning the company will need to hire 616,000 workers just to stay even. In addition, from 2004 to 2008, the company wants to add 800,000 new positions, including 47,000 management slots. "That's what causes me the most sleepless nights," Coughlin says.

At the same time, Wal-Mart will have to cope with intensifying grassroots opposition. The company's hugely ambitious expansion plans hinge on continuing its move out of its stronghold in the rural South and Midwest into urban America. This year, the company opened what it describes as "one of its first truly urban stores" in Los Angeles, not far from Watts. Everyday low prices no doubt appeal to city dwellers no less than to their country cousins. But Wal-Mart's sense of itself as definitively American ("Wal-Mart is America," boasts one top executive) is

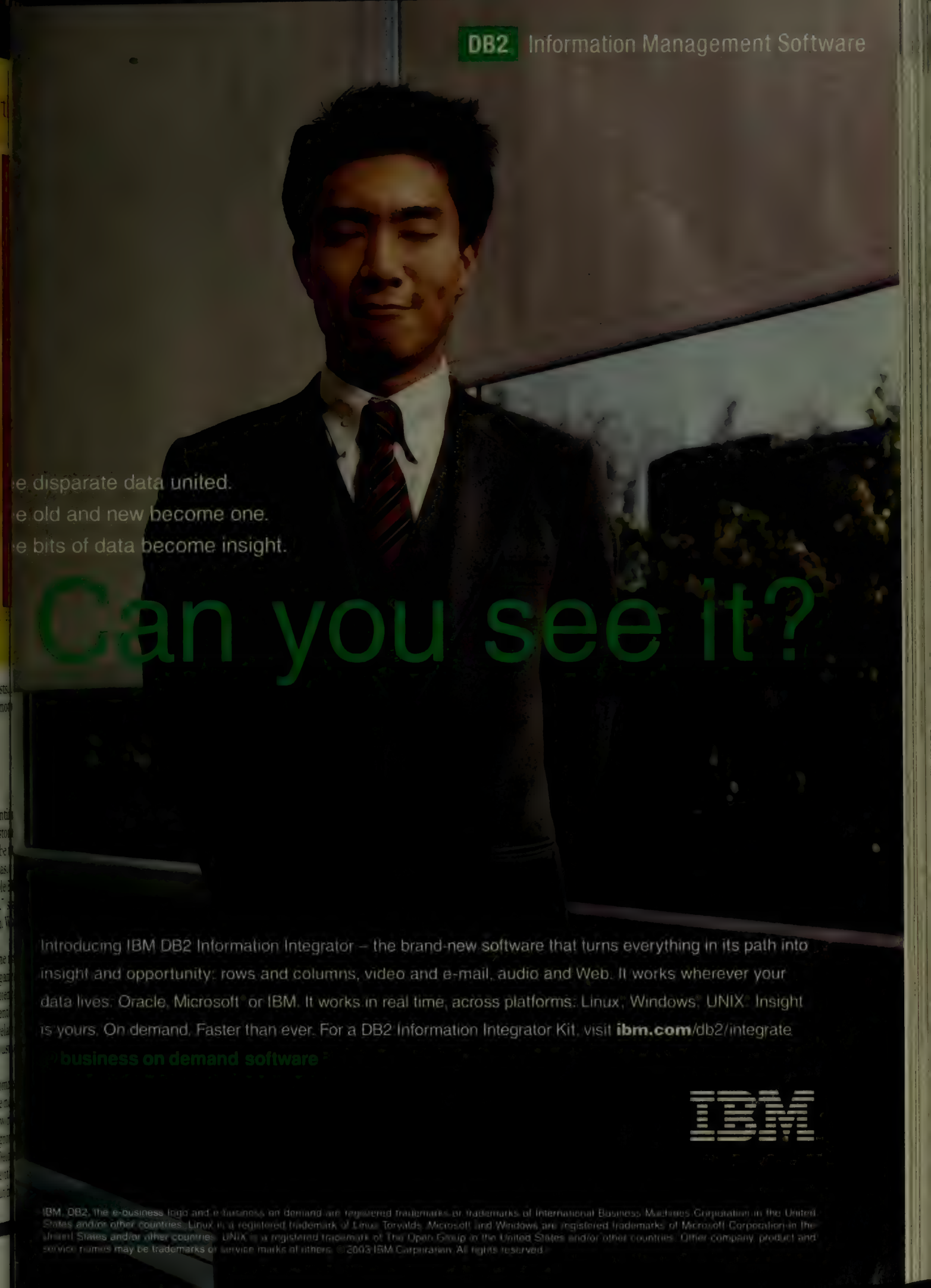
likely to be severely tested by the metropolis' high land costs, strict zoning codes, and combative labor unions—no mention its greater economic and cultural diversity.

A ZERO-SUM GAME?

CERTAINLY, WAL-MART WILL BE hard pressed to continue censoring its product lines using the justification of customer preference. The market for profanity-laced hip-hop may be tiny in Bentonville, Ark., but it is big in Los Angeles. Overseas, the company does not presume to impose a small-town, Bible Belt moral agenda on shoppers. "We adopt local standards," says John B. Menzer, CEO of Wal-Mart's international division. Well, then, should Los Angeles be any different?

The fact is, Wal-Mart doesn't know for certain how the majority of its customers feel about *Maxim*, or any other magazine for that matter. It appears that the company makes no scientific attempt to survey shoppers about entertainment content. It responds in ad hoc fashion to complaints lodged by a handful of customers and by outside groups, which are usually but not always of the conservative persuasion.

On the other hand, the company seldom submits to community groups that oppose its plans to build new stores. The number of such challenges has increased steadily and is now running at about 100 a year. Wal-Mart's "biggest barrier to growth is...opposition at the local level," says Carl Steidtmann, Deloitte Research's retail economist. The Stop Wal-Mart movement has been bolstered of late by a series of academic studies that have



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Wal-Mart by the Numbers

The world's largest company generates some amazing statistics

30	44%	4	14%	82%	71%
Supermarkets closed since Wal-Mart saturated Oklahoma City	Turnover rate for Wal-Mart's hourly workers per year	Number of Wal-Marts in Vermont, the fewest of any state	How much lower average grocery prices are where Wal-Mart competes	Percentage of U.S. households that made a Wal-Mart purchase last year	Price drop for George jeans at Britain's Asda since Wal-Mart bought it in '99
Data: Retail Forward Inc.	Data: Wal-Mart Stores Inc.	Data: Wal-Mart Stores Inc.	Data: UBS Warburg	Data: Retail Forward Inc.	Data: Wal-Mart Stores Inc.

debunked the notion that a new big-box store boosts employment and sales and property-tax receipts. "The net increases are minimal as the new big-box stores merely capture sales from existing business in the area," concludes a new study of Wal-Mart's impact in Mississippi. "I see it pretty much as a zero-sum game," says co-author Kenneth E. Stone, an economics professor at Iowa State University.

The most hotly contested battleground at the moment is Contra Costa County, near San Francisco. In June, county supervisors enacted an ordinance that prohibits any retail outlet larger than 90,000 square feet from devoting more than 5% of its floor space to food or other nontaxable goods. Wal-Mart promptly gathered enough signatures to force a referendum, scheduled for March. Complains County Supervisor John Gioia: "Local planning should be done by our locally elected board and not by a corpo-

rate office in Bentonville, Arkansas." Robert S. McAdam, Wal-Mart's vice-president for government relations, says corporate-sponsored referenda, which Wal-Mart has promoted elsewhere in California, are "a perfectly legitimate part of the process."

SUPERCENTER NATION

MEANWHILE, THE UNITED FOOD & Commercial Workers union is stepping up its long-standing attempts to organize Wal-Mart stores, with current campaigns in 45 locations. UFCW locals that represent grocery workers, the issue is nothing less than survival. The Wal-Mart supercenter—the principal vehicle of the company's expansion—is a nonunion daguerreotype aimed at the heart of the traditional American supermarket, nearly 13,000 of which have closed since 1992.

Patterned after the European hypermarket, the supercenter is a combination supermarket and general merchandise store on a counter built to colossal scale. Wal-Mart didn't introduce the supercenter to America, but it has amassed a 79% share of the category since it moved into food and drug retailing by opening its first such store in 1988. Today, Wal-Mart operates 1,386 supercenters and is the nation's largest grocer, with a 19% market share, and its third-largest pharmacy, with 16%.

Wal-Mart plans to open 1,000 more supercenters in the U.S. alone over the next five years. Retail Forward estimates that the supercenter blitzkrieg will boost Wal-Mart's grocery and related revenues to \$162 billion from the current \$82 billion, giving it control over 35% of U.S. food sales and 25% of drugstore sales. Market-share gains of such magnitude in a slow-growth business necessarily will come at the expense of established competitors, especially the unionized ones, which pay their workers 30% more on average than Wal-Mart does, according to the UFCW. Retail Forward predicts that for every new supercenter that Wal-Mart opens, two supermarkets will close, or 2,000 all told.

To the low-price, low-cost operator go the spoils. Isn't that how capitalism is supposed to work? Certainly, the supercentering of America can be expected to result in huge savings at the cash register. On average, a Wal-Mart supercenter offers prices 14% below

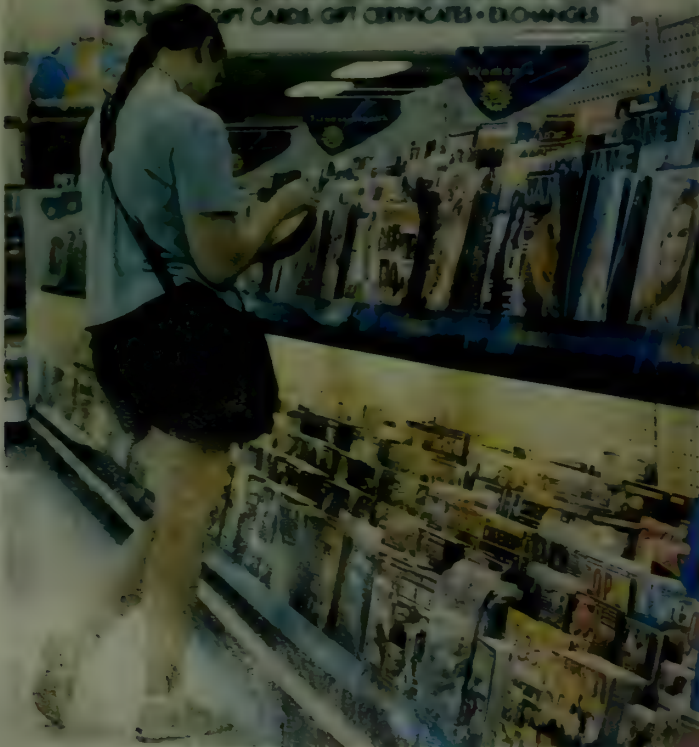
its rivals', according to a 2001 study by UBS Warburg.

MINOR MATTERS Wal-Mart has eliminated titles it considers bad for kids

However, those everyday low prices come at a cost. As the nu-

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KNOW. NOW.

The "Made in America" campaign started by Sam Walton in the '80s has been de-emphasized

ber of supermarkets shrinks, more shoppers will have to travel farther from home and will find their buying increasingly restricted to merchandise that Wal-Mart chooses to sell—a growing percentage of which may be the retailer's private-label goods, which now account for nearly 20% of sales. Meanwhile, the failure of hundreds of stores will cost their owners dearly and put thousands out of work, only some of whom will find jobs at Wal-Mart, most likely at lower pay. "It will be a sad day in this country if we wake up one morning and all we find is a Wal-Mart on every corner," says Gary E. Hawkins, CEO of Green Hills, a family-owned supermarket in Syracuse, N.Y.

For suppliers, too, Wal-Mart's relentless pricing pressure is a mixed blessing. "If you are good with data, are sophisticated, and have scale, Wal-Mart should be one of your most profitable customers," says a retired consumer-products executive. Unlike many retailers, the company does not charge "slotting fees" for access to its shelves and is unusually generous in sharing sales data with manufacturers. In return, though, Wal-Mart not only dictates delivery schedules and inventory levels but also heavily influences product specifications. In the end, many suppliers have to choose between designing goods their way or the Wal-Mart way. "Wal-Mart really is about driving the cost of a product down," says James A. Wier, CEO of Simplicity Manufacturing, a lawn-mower maker that decided to stop selling to Wal-Mart last fall. "When you drive the cost of a product down, you really can't deliver the high-quality product like we have."

Critics also argue that Wal-Mart's intensifying global pursuit of low-cost goods is partly to blame for the accelerating loss of U.S. manufacturing jobs to China and other low-wage nations. "It's hard to tease out, but Wal-Mart is definitely part of the dynamic, and given its market share and power, probably a significant part," says Jared Bernstein, a labor economist at the liberal Economic Policy Institute. The \$12 billion worth of Chinese goods Wal-Mart bought in 2002 represented 10% of all U.S. imports from China.

For obvious reasons, Wal-Mart has de-emphasized the "Made in America" campaign that founder Sam Walton started in the mid-1980s to great promotional effect. "Where we have the option to source domestically we do," says Ken Eaton, Wal-Mart's senior vice-president for global procurement. However, he adds, "there are certain businesses, particularly in the U.S., where you just can't buy domestically anymore to the scale and value we need." In recent years, Wal-Mart increasingly has sought additional cost advantages by bypassing

middlemen and buying finished goods and raw materials from foreign manufacturers. By contracting directly with a handful of denim manufacturers in Southeast Asia, the company driven down the retail price of the George brand jeans it sells in Britain and Germany to \$7.85 from \$26.67. Says Eaton: "The mind-set around here is, we're agents for our customers."

"THE WAL-MART PHENOMENON"

WAL-MART'S PHILOSOPHY DOESN'T CUT any ice with Wilbur L. Ross Jr., a financier and steel tycoon who soon closed on the purchase of beleaguered textile manufacturer Burlington Industries Inc. Ross contends that Wal-Mart's cost-cutting Americans jobs "not only as a business strategy, but as a lobbying strategy"—that is, by using its influence in Washington to oppose import tariffs and quotas and promote free

trade pacts with Third World countries, including the Southeast Asian countries that supply Wal-Mart with denim. "Everybody is now scurrying around trying to find the lowest price points," Ross complains. "It's the Wal-Mart phenomenon."

High on a wall inside Wal-Mart's headquarters is a paper banner with a provocative question in big block letters: "Who's taking your customers?" Beneath it, a "Wanted" poster still hangs photos of the CEOs of two dozen of America's largest retailers—Target, Kroger, Winn-Dixie Stores, Walgreens, and so on. None looks very happy, perhaps because they know that the only way to get off the wall is to fail utterly. Although Kmart is reorganizing under the federal bankruptcy code, a photo of its CEO continues to hang in Wal-Mart's rogues' gallery and no doubt will remain there for as long as Kmart operates even a single store.

Growth will only add to the challenge that the Bentonville colossus reaps in new markets. There might well come a time, though, when Wal-Mart's size poses as much of a threat to the company it as it does to outsiders. "Their biggest

danger is just managing size," observes a longtime supplier. Adds Babson College's Hoopes: "The history of the last 50 years in retailing would say that if you don't like Wal-Mart, you're not a patient. There will be new models eventually that will do what Wal-Mart in, and Wal-Mart won't see it coming." Right now, though, Wal-Mart's day of reckoning seems a very long way off. ■

—With Diane Brady, Mike France, Tom Lowry, Nanette Byrnes, and Susan Zegel in New York; Michael Arndt, Robert Berke, and Ann Therese Palmer in Chicago; and bureau rep



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Trying Not to Be A Fashion Victim

Despite a style and operations revamp, Gap hasn't yet found its groove

FOR PROOF THAT GAP INC. no longer moves on the infamous gut instinct of former CEO Millard S. "Mickey" Drexler, consider the plum-colored argyle vest hanging on a mannequin in one midtown Manhattan Gap store. Something so dowdy would never have made it in Mickey's style-obsessed Gap. True, today there are no wild items like pink Capri pants that helped scare away core customers.

But there's also less visual energy and sea of gray, brown, and cream that washed over Gap's fall merchandise. Shopper Catherine Salvante, for one, is unimpressed: "Putting argyle in socks is one thing, but wearing it as my chest is something else."

Yet beneath the piles of T-shirts, denim, a lot is going on at Gap. Long seen as the most troubled segment of Gap Inc., which also includes the Old Navy and Banana Republic brands, the \$6.8 billion chain of Gap stores is radically revamping how it designs and sells clothes. Drexler, who turned Gap into a household name with better everything from khakis to fleeces, was pushed out in September

2002, after sales slid at Gap Inc. for consecutive months. With Walt Disney Co. veteran Paul Pressler at the helm, the mantra is more about marketing, customer research, and backroom efficiencies. Dapper though he may be, Pressler is largely hands-off about

actual clothes and declined to be interviewed by *BusinessWeek*, declining to executives like the new design chief Pina Ferlisi, who left niche clothing brand Theory to join in March.

Ferlisi's impact won't be felt until Gap releases its clothing for the spring season, although the holiday will bring in bolder colors. Her boss's new strategy is already showing up on store shelves and behind the scenes. Pressler has proved turnaround time, cut inventory and squeezed out other costs, which helped Gap Inc. more than triple its earnings, to \$209 million, in the second quarter ended Aug. 2, up from \$57 million a year earlier. Gap Inc.'s stock price doubled, to more than \$18 per share.

HOLIDAY GARB
Looking for a new direction



the lows it hit after Pressler came on last fall. That compares with a 30% drop in the Standard & Poor's 500 Index. So, some retail experts feel the merchandise is too derivative and uninspired, with sales higher. "Boring!" says veteran retail analyst Howard Davidowitz. Of course, customers will have the final say. That's why the company is refining its look, fit, and marketing strategy for Gap brand through focus groups, extensive staff surveys, and consumer research with Leo Burnett USA. It has divided its shoppers into several categories—such as "style conscious" and "updated classic" for women—and is tweaking its ads and products to follow. "We were very product-focused before," says Gap U.S. President Gary P. Pressler. "This is trying to balance the art with the science."

GER BUZZ

AR, THOUGH, IT'S proving hard to catch up with science. While the pants chain now has four quarters of immediate earnings, based largely on merchandise developed under Drexler, the chain's U.S. same-store sales in August were up only 1% over a year earlier. Despite easy comparisons with last year's miserable results, a vigorous back-to-school environment, and a high-profile campaign starring Missy Elliott and Madonna. Greater buzz and customer feedback aren't yet paying off at the mall. As analyst Richard E. Jaffe of UBS Investment Research argues: "Consumers are the worst people in the world to ask what they want." They don't know what they see it. And at Gap, they're probably seeing products that could just as easily show up on the shelves of J.C. Penney Co. or

**BEYOND
BASICS**
"Brighter,
happier"
clothes are
on the way

Macy's. The fit is more predictable, thanks to consumer research that has simplified most of the women's pants designs into modern and classic styles. There are occasional hits, such as hot-pink coats, cropped corduroys, and the retro argyle look. There are even hot commercials, with Italian actor Raoul Bova strutting around shirtless in tight Gap jeans. But so far there are few clothes that distinguish Gap from offerings at other chains. And more frequent discounts may be training Gap customers to buy only during sales.

Having reached out for feedback, the challenge for Pressler is to woo customers with must-have clothes. Few dispute his marketing expertise, honed in running Disney's massive theme park and resorts unit. And Pressler is nothing

if not confident, suggesting in a recent earnings call that "the dynamic mix of Madonna and Missy Elliott was frankly brilliant." But others wondered who those ads appeal to and note that few consumers think Madonna actually buys her pants at Gap.

In any case, growth ultimately will depend on Ferlisi's design team. Sure, she wants to find the next big thing. But her job is also to make sure the stores are well stocked with clothes in four main categories: "basics" such as T-shirts or underwear; "essential" wardrobe builders like black pants; "style" items that make customers feel current; and "trend" clothes aimed at the more daring consumer. The challenge, Ferlisi says, is to get the mix right while inspiring more purchases through better quality, fabrics, and details. She promises "brighter, happier" clothes next season, arguing that the chain can take more risks now that "the customer feels Gap is a trusted friend."

Maybe so. But Gap veterans know all too well that, when it comes to fashion, friendship is fleeting. ■

By Diane Brady in New York

Getting Closer to The Customer

Gap is doing things much differently today than a year ago. The jury is still out, though, on whether the new strategy will spur sales.



PRESSLER

MARKETING Instead of form marketing everyone in the chain (other than Pressler), Gap now puts ads to the test by having different buying groups of men and women

DESIGN What used to be done on gut instinct is now based more on research, including focus groups and staff surveys

PRODUCTS Having struck out with a wide range of color and style choices, Gap is zeroing in on fewer but more segmented offerings

LEADERSHIP Micromanagement by former CEO Drexler has been replaced by new boss Pressler's hands-off leadership

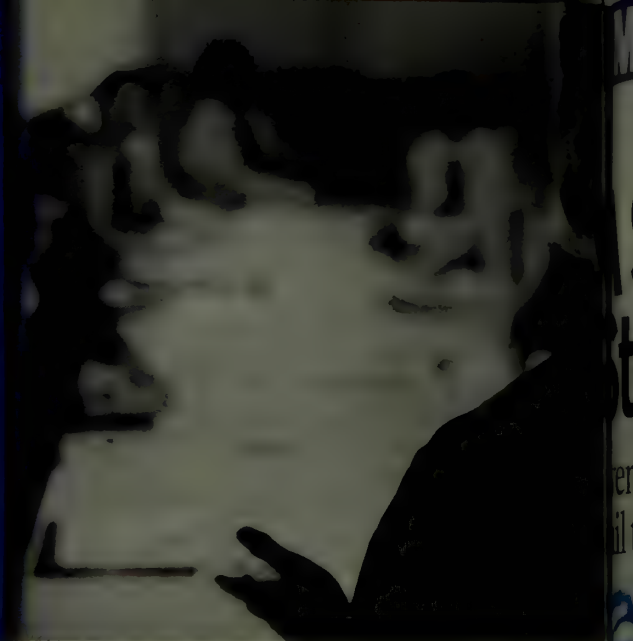


(TOP TO BOTTOM) PHOTOGRAPHS BY SABRINA GRANDE (3); EVAN KAFKA

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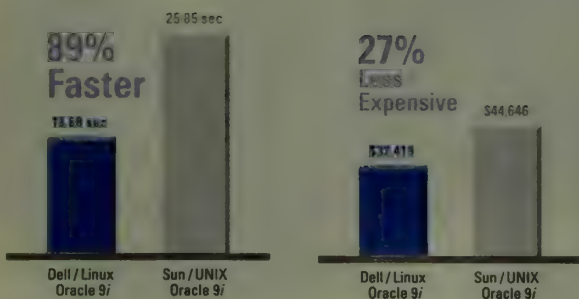
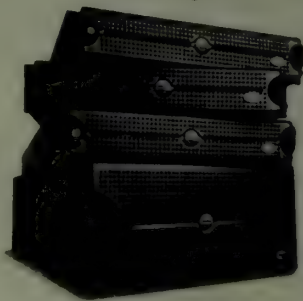
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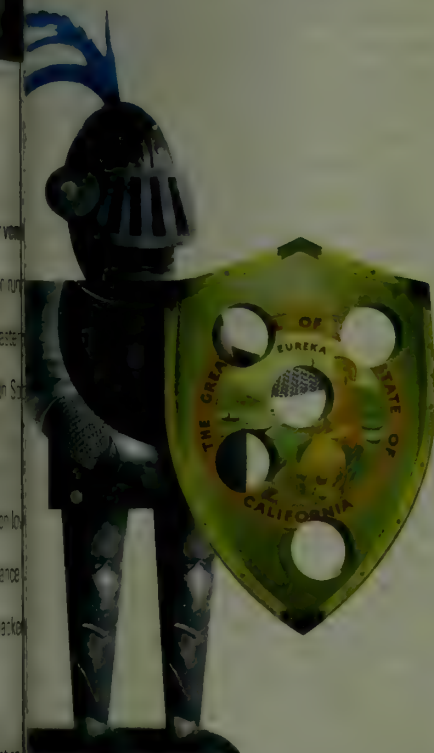
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*Based on IDC Quarterly Server Tracker, June 2003. Tests by Dell in January 2003 on baseball database. Dell configuration: Dell PowerEdge 6650 server with four 2.0 GHz Xeon MP processors, Red Hat Linux Advanced Server 3 Year Gold Support. Price: \$32,419 (www.dell.com, 7/1/03). Sun configuration: Sun Fire V480 server with four 900 MHz UltraSPARC III processors, Solaris 9 (12/02 version), 3 Year Gold Support. Price: \$44,646 (www.sun.com, 7/1/03). For details and results, see www.dell.com/migration.

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A Stab at Stemming Spam

Even California's tough new law won't nail the worst offenders



A NATION OF E-MAILERS is fed up with the daily deluge of spam. And California is offering relief. Governor Gray Davis signed on Sept. 23 the toughest anti-spam law in the land. Similar laws could spread to other states and even influence bills under consideration in Washington. The question for Netizens, though, is whether a slew of tough laws will empty unwanted ads from in-boxes. California's law, scheduled to go into effect on Jan. 1, will likely face a host of legal challenges from direct marketers. De-are all but certain. But it establishes a final model with sharp teeth. It targets not only spammers but also the advertisers they represent. It lets consumers sue. And it threatens to bludgeon spammers with fines of up to \$1,000 per unwanted mail originating in the state or

landing in a California in-box. For a spammer who sends 50 million messages a day, that's lots of potential California liability, since the Golden State accounts for as much as one-fifth of U.S. e-mail.

But here's the rub: The most egregious mail comes from some 200 spammers who are notoriously hard to locate. They reroute their traffic on an hourly basis, often bouncing it off servers in Korea, China, or Russia. And many businesses they represent are scam artists, equally elusive, or fly-by-night snake-oil merchants who can work from post-office boxes offshore.

And spam-weary citizens can expect a continued flow from bulk mailers who operate openly. These extend from catalog companies and e-tailers to the vast direct-marketing industry. These mailers stay legal, by California standards, by following an opt-in policy. That is, folks who check a box to let Amazon.com Inc. send mail can expect to receive it. Fair enough.

The problem is that opt-in permissions can be bought and sold. This greatly adds to the potential for unwanted mail. Many Web surfers click on a sweepstakes or software offer without reading the fine print. With that, they often unwittingly opt in to future e-mails—not just from the one salesman but from everyone who buys or rents his list. "I can give you the [computer] address and service that everyone on my mailing lists signed up for," says Annie Coryat, president of Gracie Media, a Lighthouse Point (Fla.) company that sends out 20 million e-mail ads a day.

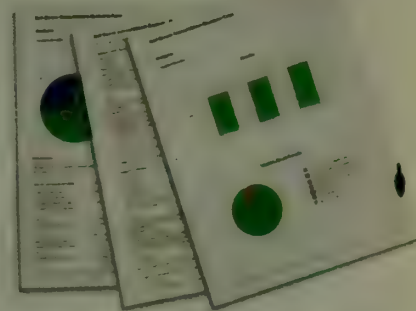
California's law could lead to a flood of lawsuits against direct marketers, rocking their industry. The focus there will be on opt-in lists, and whether they're legit. Meanwhile, look for criminal spammers—the ones who don't trouble themselves with opt-in—to keep spewing their e-trash. There's no end in sight to spam. ■

—By Stephen Baker in New York

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COMMENTARY

BY RICHARD S. DUNHAM AND STAN CROCK

A Growing Gap in Bush's Armor?

The Dems think he's vulnerable on national security. They should tread careful

WHILE PRESIDENT BUSH struggles with an Iraq intervention that seems increasingly off the rails, Democratic strategists are beginning to reexamine an ancient premise. For years, conventional wisdom held that Democrats benefited when the economy headed south and Republicans ruled when foreign policy was

uppermost in voters' minds. Now, however, the Dems are girding for the 2004 drive to oust Bush with growing confidence in their ability to win the debate over national security. Small wonder. While laments over lost jobs remain a staple on the stump, Democratic political pros suspect that the economic landscape may improve substantially by 2004. Iraq, on the other hand, looks like a black hole that could get blacker. "The real issue of 2004 is national security," says Bob Shrum, a top adviser to Presidential candidate John F. Kerry.

One sign that Dems see an opening is the Sept. 17 decision of retired General Wesley K. Clark to jump into the Presidential race with a blast at Bush-style unilateralism. His decision may

have been hastened by a flurry of polls showing the President's vulnerability on what was once his signature issue. In fact, a new Gallup Poll finds that public support for intervention in Iraq has dropped from 76% in April to 50% today. "If the opposition party doesn't talk about [this], they're complete idiots," says Democratic consultant James C. Carville.

But with the increasingly bold attacks on Bush's *machismo* comes an additional burden for Democratic hopefuls: more scrutiny of their policy alternatives. Already, Clark has flip-flopped on his support for a preemptive war against Iraq, and former Vermont Governor Howard Dean had to back away from suggesting that he might alter Bush's pro-Israel tilt. "It's awfully hard to keep track of where Democrats are," says Republican National Committee Chairman Ed Gillespie. He is convinced that an assault on Commander-in-Chief Bush will backfire. Moreover, Bush's challengers have yet to come up with compelling solutions to the Iraq mess and America's tarnished image around the world.

IRAQ WOES. Democrats were split on whether a preemptive war to oust Saddam Hussein was justified. But they all agree on one thing now: The White House has botched the postwar by thumbing its nose at the U.N.—at least until now—and failing to do proper occupation planning. The consensus solution: a rapid turnover of power to an indigenous Iraqi Governing Council and with it, an infusion of U.N.-sanctioned peacekeepers and aid money. Connecticut Senator Joseph I.



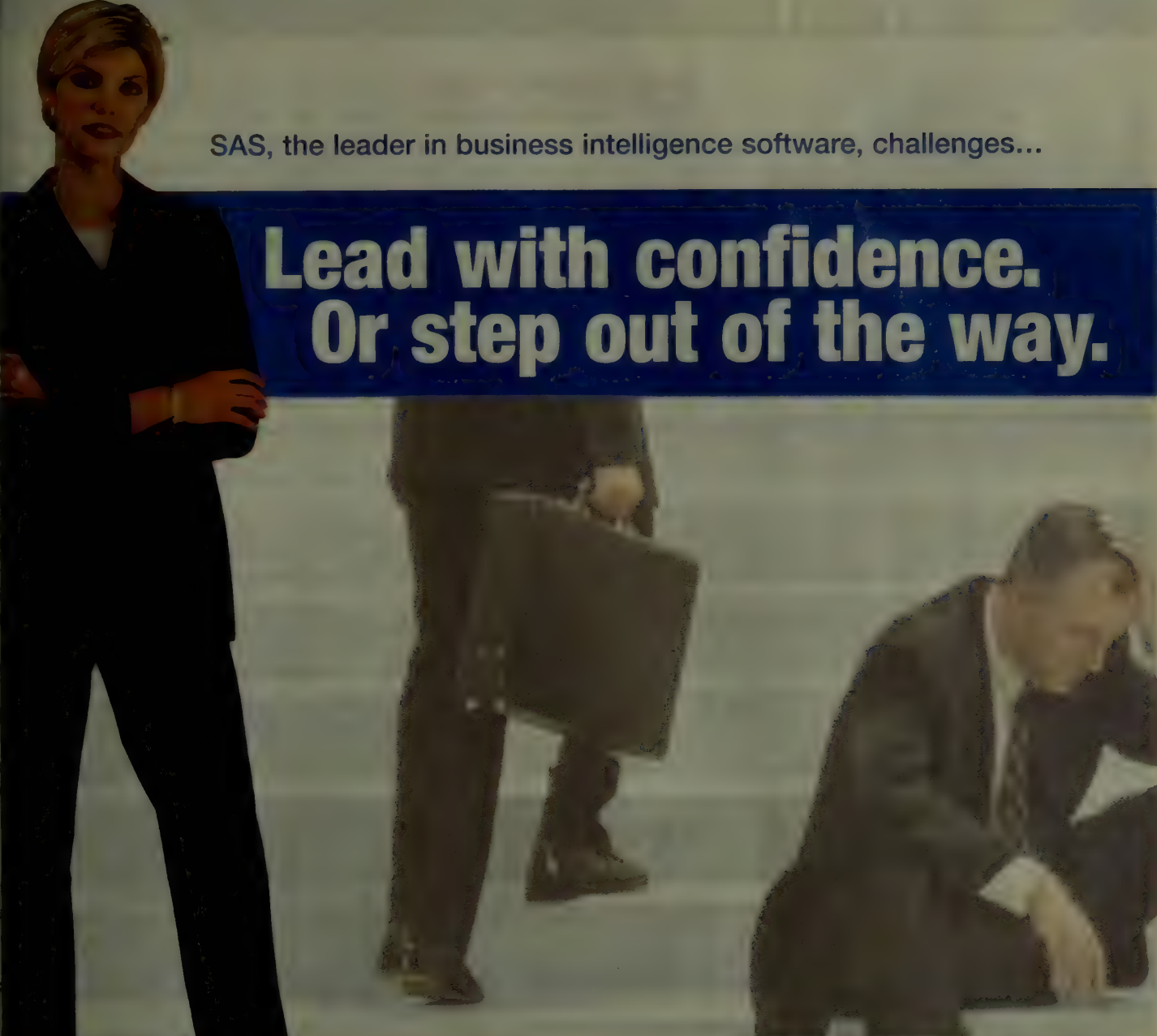
IRAQ

PINNED DOWN?
U.S. troops near
where Saddam's
sons were killed



PALESTINE

FUTILITY
Boys in
Jenin vs. an
Israeli tank



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NORTH KOREA



THREATENING
On parade in
Pyongyang

Lieberman calls for Iraqi self-rule within 60 days and reconstruction chores to be assumed by a non-American. Dean says a contingent of 50,000 foreign troops could help stabilize Iraq and allow an earlier homecoming for American soldiers.

Democratic calls for "internationalization" of Iraq are appealing, but experts say it isn't as simple as it sounds. For starters, many countries are reluctant to validate a war they view as a breach of international law. Besides, France's dream of a European counterweight to U.S. "hyperpower" means that even with Bush's new entreaties to the U.N., little in the way of troop contingents or aid money will be provided. Similarly, Dems' calls for a heavily Islamic force in Iraq look like a pipe dream. Pakistan, India, and Turkey have resisted pleas for troops.

The harsh reality: While the U.N. can help with relief chores, it will be of limited use in counterinsurgency operations. "From a policy standpoint, it is unrealistic" to expect a huge helping hand from U.S. allies, says Professor Michael Mandelbaum of the Johns Hopkins School of Advanced International Studies.

INFINITE INTIFADA. Democrats contend that Bush's initial reluctance to get deeply involved in mediating the Israeli-Palestinian dispute contributed to the unraveling of the peace effort championed by Bill Clinton. Dean would even enlist Clinton as a top-level peace negotiator.

Trouble is, this overlooks the fact that Clinton's exertions ended in failure. And since Dems are reluctant to pressure the Sharon government on contentious issues such as Jewish settlements, it's hard to see how they would do any better than Bush in breaking the bloody status quo.

NO NUKES. According to Dems, the Administration's aversion to direct talks with North Korea and Iran made it harder to rein in their nuclear programs. Lieberman would resume Clinton-era talks with Pyongyang without preconditions. Dean would grant North Korea's demand for a U.S. nonaggression pact.

But while the Democrats assail Bush's North Korea stance, his strategy of using China to pressure Kim Jong Il may be

yielding progress—albeit slowly. In addition, experts note that a yearning for a return to Clintonism overlooks the fact that the North betrayed the U.S. by launching a secret weapons program.

CHINA CARD. Democrats charge that Bush coddling China for fear of jeopardizing lucrative U.S. business deals. Meantime, critics say, Beijing keeps the yuan artificially low, floods the U.S. with cheap goods. The answer for candidates such as Missouri Representative Dick Gephardt: limit market access until China and other "unfair traders" get in line.

But the Demo-barbs ignore a key point: evolving China has become useful to the U.S. on issues ranging from North Korea to combating terrorism. And a trade showdown

now could harm the global recovery and multinationals' prospects for expansion.

For the moment, the Democrats are too busy firing broadsides to pay much attention to the complexities of the issues they are distilling into sound-bites. But if one of the White House wannabes actually winds up in the Oval Office, one thing is certain: The victor will discover that the real world is a lot more complicated than it looked from New Hampshire. Just ask George W. Bush. He blasted Clinton's nation-build and promised "a humble foreign policy" built on global alliances. Sounds kind of quaint today, doesn't it? ■

—With Lee Walczak in Washington

Foreign Policy Flash Points

The Democratic Presidential candidates all skewer President Bush's handling of foreign policy, but how would they handle things differently?



CLARK



DEAN



KERRY



GEPHARDT

IRAQ Democrats are willing to trade some degree of control over postwar Iraq in exchange for international financial assistance and the sort of broader multinational force Clark advocated before the invasion. Only Lieberman would increase the U.S. military presence.

THE MIDEAST Democrats accuse Bush of squandering the best chance in a generation to bring peace to Israel and Palestine. They say that, unlike Clinton, he has not been sufficiently involved in the peace process and has been unwilling to invest enough time and prestige to save his ill-fated "road map." Dean would draft Clinton as an emissary.

NORTH KOREA Dems say Bush provoked the North's escalation by walking away from bilateral negotiations started by the Clinton Administration. Dean says he'd promise not to invade the North in exchange for a return to real dialogue—something the White House won't consider until Kim Jong Il agrees to abandon his nuclear program.

CHINA Bush is soft on China, his challengers charge, because he doesn't want to jeopardize U.S. business ties. As a result, they say, China is manipulating its currency, failing to live up to trade agreements, and abusing human rights. Kerry would ask the WTO to crack down on China for unfair trade practices.

TRADE Bidding for union votes, the Democratic field has abandoned the free-trade rhetoric of the Clinton years to embrace the concept of "fair trade." All would demand labor and environmental protections as a condition of future trade pacts. Gephardt and Dean would seek to reopen current agreements wringing concessions from trading partners.

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What's Squeezing Banks

They're loaded up on mortgage-backed securities—and the refi boom is ending

EVER SINCE THE ABRUPT interest-rate spike over the summer, bankers have been biting their fingernails. Large lenders from Washington Mutual Inc. to Countrywide Financial Corp. have trimmed their profit forecasts, mortgage companies have gone belly-up, and big investors in mortgage-backed securi-

ties have lost their shirts. Rates have eased a bit since then, but the nervousness remains. "We're likely to see a fairly large interest-rate move in the not-too-distant future," says Jeffrey E. Gundlach, who manages \$32 billion in mortgage-backed securities for TCW, an investment firm in Los Angeles. "It can get much worse."

Rates have shot up before, of course, but this time things are different. They're

coming off 45-year lows, after creating an unprecedented boom in mortgage financing, and record issuance of mortgage-backed securities (MBS). The taste of just how dangerous the shock came after the Federal Reserve short-term rates by 0.25 percent points on June 25, less than expected. Bond prices plunged, causing Treasury and MBS yields to surge. In the quick move since 1927, the yields on 10-year bonds hit 4.5% by the end of August from its low of 3.1% on June 13. In a span of 60 days, the Lehman Brothers Treasury Index lost 11.6%.

The last surprise upswing in rates, 1994, had its casualties, too—but tr

5 trillion MBS market passes the size of the Treasury market. How did it get so large? Instead of buying mortgages they sold them to Wall Street, which, in turn, bundled them and created fixed-income securities backed by mortgage pools. MBS comprise almost half of the \$3.6 trillion in new bond offer-

ings this year, according to the Bond Market Association. Mutual funds, pension funds, endowments buy these securities—so do banks. Financial institutions prefer to hold them rather than holding mortgages directly because they offer diversity and liquidity.

Here's how the problem begins. When rates rise, fewer homeowners refinance instead stick with their existing low-rate mortgages. That means, on average, the loans that back a particular security will take longer to pay off. So, a security that investors expected to have a four-year maturity now has a 10-year expected life. Those longer-term assets make the institution's overall portfolio more sensitive to higher rates. Banks try to offset this increased risk by selling long-term assets, such as Treasuries, which in turn forces Treasury yields higher. James Bianco of Bianco Research, a fixed-income specialist in Chicago, says the sheer volume "drives interest rates as much as Fed policy."

SNOWBALL EFFECT

WHAT IS THIS MARKET that the small uptick in interest rates now sets off a violent ripple effect. For every one-half-of-a-percentage-point rise in the 10-year Treasury bond yield, MBS holders must reduce their portfolio by selling about \$1 billion worth of Treasuries. That forces down rates further and forces banks and other MBS holders to sell yet more Treasuries. "We have to sell hundreds of billions of Treasuries or their equivalent, but the market simply can't absorb that much," says Doug Greenig, head of mortgage trading and derivatives at Greenwich Capital. Selling pressure forces higher yields, which begets more selling. "It's the classic snowball effect." Ultimately, these assets could put banks at risk. Consider that at least six sizable institutions—Commerce Bancorp of New Jersey, Cincinnati's Fifth Bancorp, Charter One Financial in Cleveland, Roslyn Bancorp in Jericho, New York, and Baltimore's Provident Bank-

Now even the smallest uptick in rates sets off a violent ripple effect

shares—have from 28% to 51% of their earning assets in mortgage-backed securities, according to Standard & Poor's. As rates rise, the unrealized loss from the market value decline of the MBS holdings could be very high. Says S&P credit rating analyst Victoria Wagner: "In the past, banks that invested their assets this heavily in MBS experienced unrealized

losses as high as 22% of total capital."

So far, most lenders are holding on to their MBS portfolios. They now own \$706 billion in mortgage-backed securities, according to analyst Adam Compton of Dresdner RCM Global Investors. Worse, he says, half of the MBS are backed by fixed-rate mortgages of more than 15 years, making them ultrasensitive to rate changes. Still, he says, commercial banks have sold only \$63 billion worth of mortgage-backed securities through the end of August. Adds TCW's Gundlach: "Banks either have to take some pain today, or do nothing and expose themselves to three times the pain later."

How much pain is anyone's guess. Why? Because banks don't have to account for losses in these securities unless they sell them. "Unfortunately, we believe the market is using an accounting system that masks the impact of interest rate changes on bank earnings and bank balance sheets," says Morgan Stanley's large-cap bank analyst, Betsy Graseck, in her Sept. 19 industry report.

The safest strategy for most banks is to hedge their mortgage portfolios. That's an expensive choice in the face of diminishing profits, but a necessary one. Further losses may be averted if rates contin-

ue to climb. Consider that during the two and a half years of the refi boom, hedging cost the 20th-largest mortgage lender—Pasadena (Calif.)-based IndyMac Bancorp Inc.—\$372 million in earnings on \$716 million of loans. Had it not hedged, its margin on the loans would have been 2.55%, vs. 1.68%, says CEO Michael W. Perry. Since the end of June, however, hedging has prevented \$157 million in losses, he says. "You can make a lot of money playing it a little bit fast and loose," he says of competitors that don't opt to hedge. "But now everyone's risk management is getting a stress test."

DOWN TO A TRICKLE

FAILING TO HEDGE when rates are moving against you—either up or down—can put those MBS players out of business. That's what happened to Capital Commerce Mortgage, a Sacramento (Calif.) mortgage originator, which abruptly closed shop last month after failing to hedge against rising rates. Conversely, New Jersey's Beacon Hill Asset Management lost \$4 billion and folded last October after its fund managers had taken a large, highly leveraged short position in U.S. Treasuries in July, betting wrongly that interest rates would rise.

That banks will suffer losses in their mortgage portfolios is a given. The end of the refi boom has slowed a river of fees to a trickle. Will other revenues pick up? Maybe an improving economy will spark loan demand, but for now commercial lending is flat. True, higher interest rates ultimately boost the banks' net interest margins—the difference between a bank's interest income and what it pays to depositors. Until then, nails certainly will have been bitten to the quick. ■

—By Mara Der Hovanesian in New

Taking A Hit

The pain of rising interest rates is already evident

CAPITAL COMMERCE

Goes bankrupt in August after failing to hedge against interest-rate moves

COUNTRYWIDE FINANCIAL

Lays off 565 mortgage employees in August after loan volume drops

NATIONAL CITY, KEYCORP

Reports slowdowns in mortgage origination volume, and lower 2003 earnings estimates

ANNALY MORTGAGE

Halves 3Q dividend and reports losses of about \$50 million in previous quarter

WASHINGTON MUTUAL

Expects a third-quarter loss from the sale of mortgage loans

Tech IPOs Run Out of Tricks

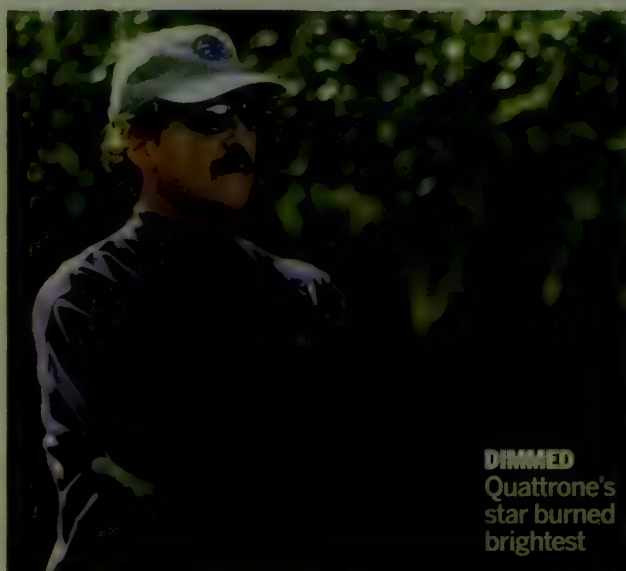
Now that tactics for inflating their prices are taboo, deals are way down—and smaller

TECHNOLOGY STOCKS ARE up 40% since January. Corporate spending on computer equipment is on the mend. And on Sept. 23, Pocatello (Idaho)-based semiconductor chip-maker Amis Holdings raised \$600 million in the biggest tech initial public offering since hard-drive maker Seagate Technology was listed almost a year ago.

But if there are any investors who still think the days of eye-popping tech IPOs will return some day, they're likely to be disappointed. As the trial of ex-Credit Suisse First Boston star tech banker Frank Quattrone begins—he goes to court on Sept. 29, on obstruction-of-justice charges he denies—industry observers from Wall Street to Silicon Valley say tech banking's Wild West days are gone. From now on, the first-day returns on most tech offerings are expected to stay closer to earth, 35% on average—a far cry from the heady days of 1999, when IPOs shot up as high as 700%. Indeed, Amis's offering rose a modest 0.5% in its first day of trading.

TAKE A NUMBER

IT SEEMS THAT tech banking is growing up. Just as the junk-bond business settled down after the collapse of Michael R. Milken's Drexel Burnham Lambert Inc. in 1990, tech banking is evolving into a more normalized operation at many investment banks. One big reason is that most of the tricks that Wall Street used to pump up IPO prices are now forbidden. Bankers can no longer help analysts get fat bonuses in return for positive reports. They cannot promise their IPO companies stellar research ratings or even coverage. And since Wall Street has drastically downsized its tech-banking



DIMMED
Quattrone's
star burned
brightest

Brave New Offerings

In the aftermath of the Wall Street scandals, tech investment banking is changing. Here's how:

FEWER DEALS Burned investors are scrutinizing tech companies' IPOs more carefully. Fewer companies are meeting the higher bar.

LOWER RETURNS New rules are restraining banking practices that guaranteed big first-day pops in IPO prices.

TENSE RELATIONS Bankers can no longer promise favorable research coverage—upsetting tech companies.

teams—by 70%—bankers are pickier about which potential IPO candidates they will spend their time wooing.

Many IPOs are not getting to market at all. Only 10 U.S. tech and Internet-related startups have gone public so far this year, down from 365 in 1999. In the '90s, the average was 155 a year, according to re-

search firm Dealogic, and anything that is out of reach for the foreseeable future. "I cannot see Morgan Stanley doing more than 10 tech IPOs a year," Dhiren Shah, head of global tech bank at Morgan Stanley. The firm handled tech IPOs in 1999.

LOOKING FOR REVENUES

MOST OF THE DEALS getting done are much smaller these days. "The typical billion market-cap tech underwritten in 1999 is now a \$100 to \$200 million market-cap company," says William R. Hambrecht, who runs WR Hambrecht & Co., an online IPO auction firm.

While tech banking is becoming more mundane, almost dull, for investment banks, investing in tech IPOs is riskier than ever for managers. Since bankers can't guarantee a huge first-day jump, professional investors are exercising more caution. These days, bankers say, investors are most interested in companies that have revenue of at least \$10 million a quarter—and profits. "There is a strong demand for high-quality, seasoned, attractively valued tech companies," says Brad Kohn, co-head of tech, media, and telecom at Goldman, Sachs & Co. "But there are few in the pipeline that meet the thresholds required by today's markets."

Certainly, there are some investors who may lower their standards once the stock market strengthens. Amis, for example, is no paragon of consistent profitability, though it posted profits for three years, the company reported a \$6.7 million operating loss in the quarter ended June 28. And on gift shop RedEnvelope, which listed on Sept. 1, posted a \$1 million loss during that period.

Still, that's a lot different from the investor frenzy over shares issued by startups with little more than a business plan. The rules have changed. No longer will the shares of tech IPOs soar to heavens. And that's healthy.

—By Emily Thornton in New York,
Faith Arner in Boston

October 6, 2003

This announcement appears as a matter of record only.

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COMMENTARIES

Why a Falling Dollar...

...Makes Sense

Letting the greenback drop will narrow the yawning U.S. trade deficit

BY RICH MILLER

JUDGING BY THE INITIAL REACTION of global financial markets, the call by the U.S. and its Group of Seven partners for more flexible currency rates was a disaster. Stock markets from Tokyo to New York nosedived on Sept. 22 as investors took fright at the dollar's fall after the G-7 meeting in Dubai.

Hold on. From a longer-term standpoint, the G-7 agreement—and the weaker dollar it has already helped bring about—is good for the U.S. and world economy. Provided it doesn't turn into a rout, the dollar's drop should spur U.S. economic growth and help bring down the bulging trade deficit by making U.S. exporters more competitive on world markets. It should also put any lingering fears of deflation to rest by raising prices of imports, giving hard-pressed U.S. manufacturers sorely needed pricing power. What's more, by helping to narrow the trade gap, the G-7 pact can head off

mounting protectionist pressures in Congress, including a by some members for tariffs that could prompt trade wars.

Despite a lot of loose chatter in the currency markets, the G-7 agreement is not a replay of the 1985 Plaza Accord, in which the U.S. and its allies agreed to sell the dollar aggressively to drive down its value. In some ways, the late agreement is just the opposite. The G-7, led by U.S. Treasury Secretary John W. Snow, wants the markets—not governments—mainly to determine exchange rates. That's hard to argue with, given the history of official attempts to manage currencies. Remember then-Treasury Secretary James Baker's ham-handed management of the dollar in 1987 that led to the Oct. 19 stock-market crash? And what about the Asian Tigers' efforts to peg their currencies to the dollar that led to a region-wide crisis a decade later?

Still, the G-7's advocacy of more flexible exchange rates is tantamount to acceptance of a weaker dollar. Why? Because the countries that are trying to manage exchange rates—Japan and other export-driven economies of Asia—are massively intervening in markets to keep the dollar high against their own currencies. China, which

Continued on page



...Won't Help

It'll scare off foreign investors—and do zilch to boost inefficient industries

BY MICHAEL J. MANDEL

FOR 8 YEARS, Democratic and Republican Presidents alike have mostly followed a strong dollar policy. With manufacturing jobs draining out of the U.S. like sand from an hourglass, the Bush Administration has broken with that tradition by encouraging the dollar to fall against other currencies, particular those of China, Japan, and other Asian exporters. The hope is that a weaker dollar, by making imports more expensive at home and U.S. exports cheaper abroad, will close the trade gap and stop jobs from going overseas.

But a falling dollar could have serious negative consequences without actually fixing the problems that are causing the trade deficit to widen. For starters, a weaker currency could scare off foreign investors, depressing the stock market and sending interest rates soaring. In the short run, it will also force consumers to pay more for imports and

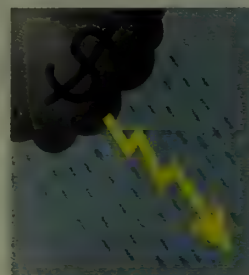
drain off money they could have used for something else, dampening growth. What's more, currency manipulations will do nothing to fix the fundamental problem: Much of U.S. manufacturing has simply not been innovating and boosting productivity fast enough to compete effectively in the global marketplace.

Consider first the impact of a falling dollar on foreign investors. The U.S. depends on an enormous flow of capital into the country to fund everything from business investment to home construction to the government budget gap. Over last year, for example, the U.S. has absorbed roughly \$800 billion in foreign capital, with most of that going into corporate bonds, Treasury debt, and mortgage-backed securities.

Any drop in the dollar big enough to cut the trade deficit

significantly—say, 15%—would also greatly reduce or eliminate the return for European or Asian investors who put their money into U.S. securities. Moreover, the prospect of further declines in the dollar would encourage foreign investors to start pulling out their funds from the U.S. stock and bond markets. The outcome could be

Continued on page



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the biggest trade surplus with the U.S., has pegged its currency rigidly at 8.3 yuan to the dollar since 1994.

During the go-go years of the late 1990s, a strong dollar was in the U.S. interest. Cheap imports helped keep inflation down and fill demand from consumers that U.S. companies couldn't meet because they were already running their plants flat-out. Now, the situation is reversed. Inflation is virtually nonexistent: Excluding volatile food and energy costs, consumer prices have risen just 1.3% over the past year. Indeed, the Federal Reserve is worried about deflation, not inflation. And U.S. factories are running at three-quarters of capacity, a 40-year low. A weaker dollar would give hard-pressed U.S. manufacturers some relief from low-priced Asian imports, especially from China. And by boosting U.S. exports, it would also give a welcome fillip to U.S. growth. William Dudley, chief economist at Goldman, Sachs & Co., says a 10% dollar drop would boost growth by about a half percentage point in a year.

WHY A FALLING DOLLAR MAKES SENSE

A weakening U.S. currency will:

- 1 Reduce the bulging trade deficit by making U.S. exports more competitive
- 2 Avert the dangers of deflation by raising the prices of imported goods
- 3 Defuse protectionist pressures in Congress

Data: BusinessWeek

spike in interest rates, much greater difficulty in raising money, and a squeeze on domestic growth.

What about the supposed benefit of reduced imports and increased exports? That certainly will happen eventually, but it takes time for exporters to gear up and for retailers to shift from foreign suppliers to domestic alternatives—if, indeed, any exist for many products. As a result, in the short run, retailers will face higher costs when the dollar declines, which they will pass on to consumers as higher prices. That leaves less money for Americans to spend on domestic goods and services. In effect, higher import prices serve as a giant tax, hitting the U.S. economy just as it finally begins to recover.

Finally, and perhaps most important, the focus on the strong dollar as the cause of the trade deficit may miss the point. The trade-weighted level of the dollar is about where it was at the middle of 1998. The trade deficit today, however, amounts to almost 5% of gross domestic product, compared with just under 2% in 1997.

There are several reasons the trade deficit has expanded so much, including the consistent ability of the U.S. to grow faster than Europe and Japan. But surprisingly, one critical factor is that, outside of high tech, productivity growth in much of manufacturing has been a lot weaker than people realize. According to just-released data from the Bureau of Labor Statistics, fully half of the 86 manufacturing industries tracked by the government had annual productivity growth of 2% or less between 1995 and 2001. One-third had productivity growth of less than 1% annually.

Without strong productivity growth, it's hard for domestic factories in these industries to hold down costs and compete effectively in global markets. Moreover, the government's figures also suggest a lack of innovation in much of

Indeed, thanks to the gradual decline of the dollar that started in February, 2001, U.S. exports are already on the and in July hit their highest level in two years. Much of the U.S. gain abroad has come at the expense of European companies, courtesy of a 35% drop of the dollar vs. the euro. If Asian nations allow their currencies to appreciate more against the dollar, that would spread the pain that would accompany the reduction in the U.S. trade deficit. If it also spurred those countries to cut interest rates and ease fiscal policy to boost demand at home to make up for the lost exports, so much the better.

One possible downside: A shift in Asian currency policy could lead to higher interest rates in the U.S. Japan, China and other Asian nations invest in U.S. Treasury securities, using the dollars they buy to support the greenback. The yield on the key 10-year Treasury note ticked up on Sept. 22 on expectations of reduced Asian purchases.

But the impact of any such cutback is likely to be muted by the Fed's determination to keep short-term interest rates super-low to ward off even the remote risk of deflation. What's more, it's not in Japan's or China's interest to force U.S. rates sharply higher by dumping Treasuries. The last thing they want to do is hurt the economy of their largest export market.

Global trade is out of whack. After the collapse of trade talks in Cancún, Mexico, flexible exchange rates are probably the best tool big economies have to try to right the balance. In Dubai, the G-7 took an important step toward putting the world economy on a firmer footing. They should be applauded, not jeered. ■■

manufacturing. That makes outsourcing much easier, since it is a lot simpler to set up factories abroad in industries where the production techniques are well understood and not changing very quickly.

The BLS data show, for example, that output per hour in the electrical equipment industry rose at only 0.5% per year from 1995 to 2001. Not coincidentally, imports of generators, transformers, and other electrical equipment from China alone totaled more than \$4.3 billion in 2002, vs. \$2.8 billion on 1998. Other industries with low productivity growth are domestic producers of industrial construction machinery, household furniture, audio and video equipment, and magnetic media such as videotapes

diskettes—and all have made significant shifts of production overseas as well.

Expecting a lower dollar to boost puny productivity is like putting a Band-Aid on an amputated limb. Either no further innovation in these industries is possible—in which case they will inevitably move to low-cost countries—or U.S. manufacturers are simply falling down on the job. Either way, a weaker greenback won't help. ■■

WHY A FALLING DOLLAR WON'T HELP

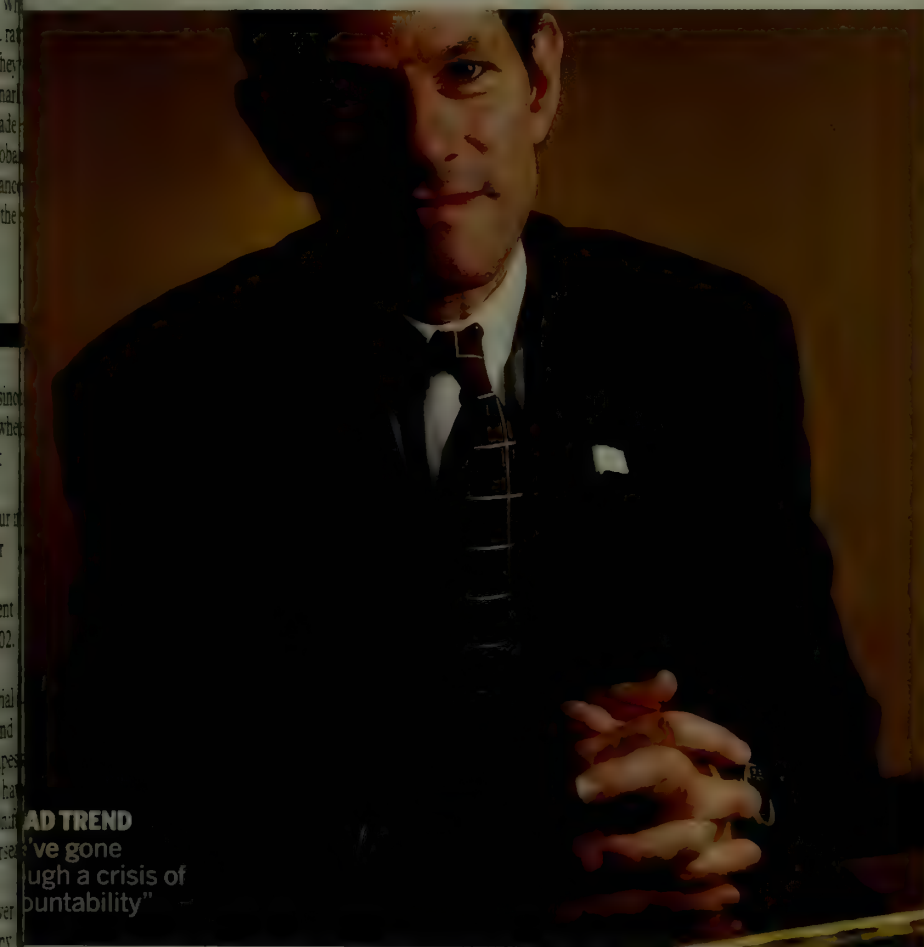
A weakening U.S. currency will:

- 1 Make foreigners less likely to invest in the U.S.
- 2 Depress growth in the short run by increasing the cost of imports
- 3 do nothing to help stagnant productivity growth in much of manufacturing

Data: BusinessWeek

Straight Talk From Eliot Spitzer

The New York AG on the mutual-fund investigations and other issues



AD TREND
"We've gone through a crisis of accountability"

MAKING ON THE POWERFUL FINANCIAL services industry that's headquartered just steps from his offices in Lower Manhattan, New York State Attorney General Eliot Spitzer has emerged as the most aggressive shareholder advocate in recent memory. He's both the people's lawyer and the most disliked person on Wall Street. Just weeks after announcing a sweeping inquiry into the mutual-fund business and two days after indicting the first alleged wrongdoer, Spitzer sat down with Editor-in-Chief Stephen B. Shepard on Sept. 18 as part of Captains of Industry series at New York's 92nd Street Y.

How optimistic are you that we have really changed the way business is done on Wall Street?

We've gone through a crisis of accountability that spanned many sectors; it was not merely Wall Street. It was government. It was not-for-profits. It was religious institutions. It was even the media. We have seen failures of governance that, to a certain extent, reflected a larger societal issue, a dislocation, a disjunction between people being put in positions of authority and their understanding of their fiduciary duties.

Now, having gone through this series of scandals, I believe there has been a fundamental change that will last for some time. For one thing, the consequence of the publicity that has attended all the scandals has shamed those who were in positions of governance to reconsider their behavior. As a consequence, boards of directors are acting in a very different manner today than they were two years ago.

In the Wall Street research investigations, why didn't you try to send anybody to jail?

When we diagnosed what was going on with respect to the research problem, [we saw] that a business model had become accepted by all of the Wall Street firms. The model had integrated research and investment banking, which led to subjugation of research to investment banking and the complete loss of integrity of research. The rules had become so ambiguous and the lack of enforcement of rules of fiduciary duty and integrity had become so pervasive that everybody was playing improperly. The rules themselves needed to be changed.

Changing the rules in midstream and going to the investment banks and saying, "We are now writing a new set of rules for you to play by," in a way undercut the validity of subsequent criminal cases. There is something problematic about saying, "We're changing the rules, but because you're playing by the old rules, we're sending you to jail." The rules should have been changed before by other enforcement entities, but that's a separate issue.

Now fast forward to the mutual fund context, where the rules are unambiguous, where what we call late trading is clearly defined as being a criminal wrong and a civil wrong. That has led to one criminal charge, and there is a good possibility there will be a significant number of other charges.

Did you ever think seriously that

somebody like Sandy Weill would be indicted?

I don't want to personalize this to Sandy, so let me tell you how we viewed every case. We examined every fact pattern to determine whether an individual and/or an institution had knowingly disseminated research that that institution or that individual did not believe to be true. We asked: "Can we prove that those who distributed the research, those who authored it, didn't believe it, and that they were writing and crafting this research for an ulterior motive because of the conflicts of interest?"

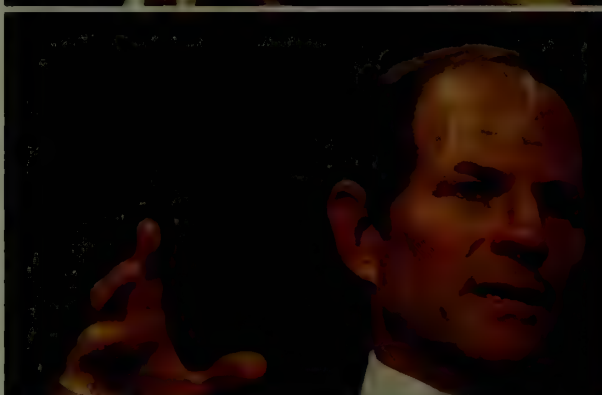
We considered [indicting a major bank] but determined that even though its behavior had been highly improper and theoretically criminal, the wiser course for the marketplace, for investors, for the economy, was to get agreement about a set of rules, prospectively have a huge restitution effort that is ongoing, and then go forward.

One particularly egregious case was the Enron off-balance sheet partnerships and their bankers. In this instance, there was no admission of guilt, no jail time, only fines. This is not your case, but what do you think about it?

I have a policy of not passing judgment on other prosecutors' resolutions. But having said that, I said forthrightly to the CEO of a major institution: "Understand something. You, collectively—as institutions, as CEOs—to a certain extent were given a pass in the past year or two. It was said to you, 'the collateral consequences to our economy, to thousands of employees, of bringing criminal actions against your institutions are so vast that we decided not to do so,'" and hence settlements such as the one you just described. I said: "Those days are over. If you have not yet learned the lesson, my tolerance and the tolerance of others who make this determination to give you the pass next time is diminished to zero."

You were not in favor of indicting the entire firm of Arthur Andersen, which subsequently went out of business.

The consequence of indicting Arthur Andersen was we went from five major accounting firms to four, and 60,000 people were thrown out of work. The indictment was predicated on destruction-of-evidence charges. That destruction of evidence was criminal. However, there was



“ Sarbanes-Oxley may go too far We have to see how it plays out ”

no corporate-wide policy to destroy evidence. Therefore, I felt that if you're going to indict the entire company and destroy the company, do it for a policy that went to the core of its business.

If you could prove that fundamentally Arthur Andersen was deceptive with its audit practices, then they deserved to be indicted. But because a small core of individuals destroyed some evidence, that did not speak to corruption throughout the entire company, and should not have been a sufficient predicate for destroying the entire company.

There are all kinds of concerns with mutual funds other than after hours trading. Is this the tip of the iceberg?

We don't know quite what dimensions of this problem are, although I will tell you that it is radiating out at a surprising and discouraging pace, meaning that the other funds being impli-

From an investor's point of view, the concerns are about excessive fees, disclosure of fees and trading costs, poor governance. Are you going to get into those things?

We might take a look at those issues, but governance issues may not be violations of law but issues of good or bad practice. That is what the Securities & Exchange Commission properly would say "here are the governance standards we expect you to live up to." It may be bad but poor practice.

Where do you draw the line about what the SEC responsibility is and what the state attorney general's is?

I have always agreed that we need uniformity in terms of the rules that dictate how our capital markets function. We do not want balkanization. That would be bad for capital formation for investors, bad for the economy.

Having said that, enforcement has always been distributed among various levels of government. We have federal, state, and local enforcement. That has been the case since the early part of the last century. In fact, the New York State securities laws preceded the federal laws by a decade. We have had this duality of enforcement for the past 80 or so years without confusion or dislocation. Perhaps an instance where there has been a lack of uniformity or where the competition of states to enforce state securities laws has led to an unfortunate consequence for the capital markets.

We have just been through this situation with the New York Stock Exchange and Dick Grasso.

What needs to be resolved are the underlying problems at the NYSE. The

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is, and hopefully will continue to be, the preeminent exchange that major companies want and have to be traded on. It lends vitality to our economy.

Do you think regulatory oversight of the New York Stock Exchange should be separated from the exchange itself?

Has that interweaving of the two functions led to a failure of regulation? Yes. So must the two somehow be separated to ensure the integrity of each? Absolutely.

[In general] I have been very critical of the self-regulatory organizations, both the NYSE and the NASD, for their failure to confront some of the structural problems. Articles have been written about the failure of research and the subjugation of research to investment banking, yet the SROs did nothing about it.

You have to believe that this was because the SROs were controlled. Their boards were dominated by the very entities that would have been subject to that regulation. So clearly that model is flawed. Something has to be done about it. The SEC is looking at that and looking at it very aggressively.

Are you concerned that in a bid to address corporate corruption, the government through Sarbanes-Oxley has made oversight too stringent?

Absolutely. The concern relates to the unintended consequences of well-meaning statutes.... Sarbanes-Oxley may go too far. I hear complaints all the time from executives, from lawyers, that too much time is being wasted on ministerial activity. We have to see how it plays out. There will be time to change it, but we're worried about that.

What do you think about the future of hedge funds?

There was a fair bit of noise about hedge funds offered to short-sellers, and everybody said: "Short-sellers are bad. Therefore, regulate them." I don't buy that logic. Short-selling is healthy in the marketplace when it is based upon honestly held beliefs. Indeed, it was the short-sellers who first revealed the problems at Enron—a bunch of hedge funds that did good, solid research that said: "Wait a minute. Enron is a house of cards." And they began to short-sell and educated the rest of the investing public. That is good.

As hedge funds are made available to a broader base of our society, and as the definition of sophisticated investor—

which is the sort of threshold you have to overcome to participate in a fund—is relaxed, greater disclosure and should be required of hedge funds. But hedge funds serve a useful function.

In light of the Iraq war and the faltering economy, will corporate ethics receive the attention they deserve in the coming Presidential election?

[The issue] has received more attention than I ever thought it would. The day before we announced the initial filing against Merrill Lynch & Co. last August, I said: "Well, this will be an interesting story for a day or two." I never dreamed it would touch a nerve in the public conscience, as all the other scandals have. The public cares deeply because [it] is invested. Elected officials, as a consequence, will care.

Now that we're on a political subject, how do you get along with [New York State] Governor George Pataki?

He's a bright individual with whom I disagree on certain policy issues, but I have made it my practice to disagree primarily in private. On the other hand, where there are theoretical disagreements, I will occasionally articulate them, such as I have recently with respect to energy and education policy. Over time, there will be more.

How do you feel about his raising money for [House Majority Leader] Tom DeLay?

I'm not going to say he can't exercise his First Amendment rights to do that. But, boy, I haven't seen Tom DeLay doing anything terribly good, either for the country or the state. Along the political spectrum, Tom DeLay seems to be rather far from where I think most of us are. So I'm not sure why he's doing it. But it's his choice. You won't find me doing it.

What would you like to do next?

What am I doing in 2006? I don't know. I have said, and I will repeat it. I have a mantra: I am considering whether to run for governor down the road. I hope I will have spent eight successful years as attorney general. I will make the decision in a year or so. But until then, I'm just been reelected, my one job is to do this job as best I can. ■

BusinessWeek online For a video version of this interview with New York State Attorney General Eliot Spitzer, go to www.businessweek.com/mediacenter/



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Frank Gehry's High-Tech Secret

As his renown reaches a peak, the visionary architect wants to market the 3-D software that turns his complex ideas into precise blueprints and prevents costly surprises

IT RISES LIKE AN ENORMOUS steel flower in downtown Los Angeles. It's a symphony hall for modern times, with exposed steel beams, bolts and pipes, stone floors, and blond wood, all coming together at improbable angles. The building's brushed-steel skin gleams in the Southern California sun. At night, it falls ominously dark, a giant piece of industrial sculpture in the midst of perfunctory high-rise office buildings. Los Angeles boosters are already calling it the city's Eiffel Tower. And they can't help but hope that it might lead to the renaissance of a downtown long ago marginalized in the capital of suburban sprawl.

The Walt Disney Concert Hall, which opens on Oct. 23 and will be the home of the Los Angeles Philharmonic, is more than just a trophy property for the City of Angels. It is also the culmination of a 16-year struggle for the building's architect, hometown hero Frank O. Gehry, an experience that has convinced him more than ever of the need for fundamental change in how buildings come to be. In almost any project, and especially in



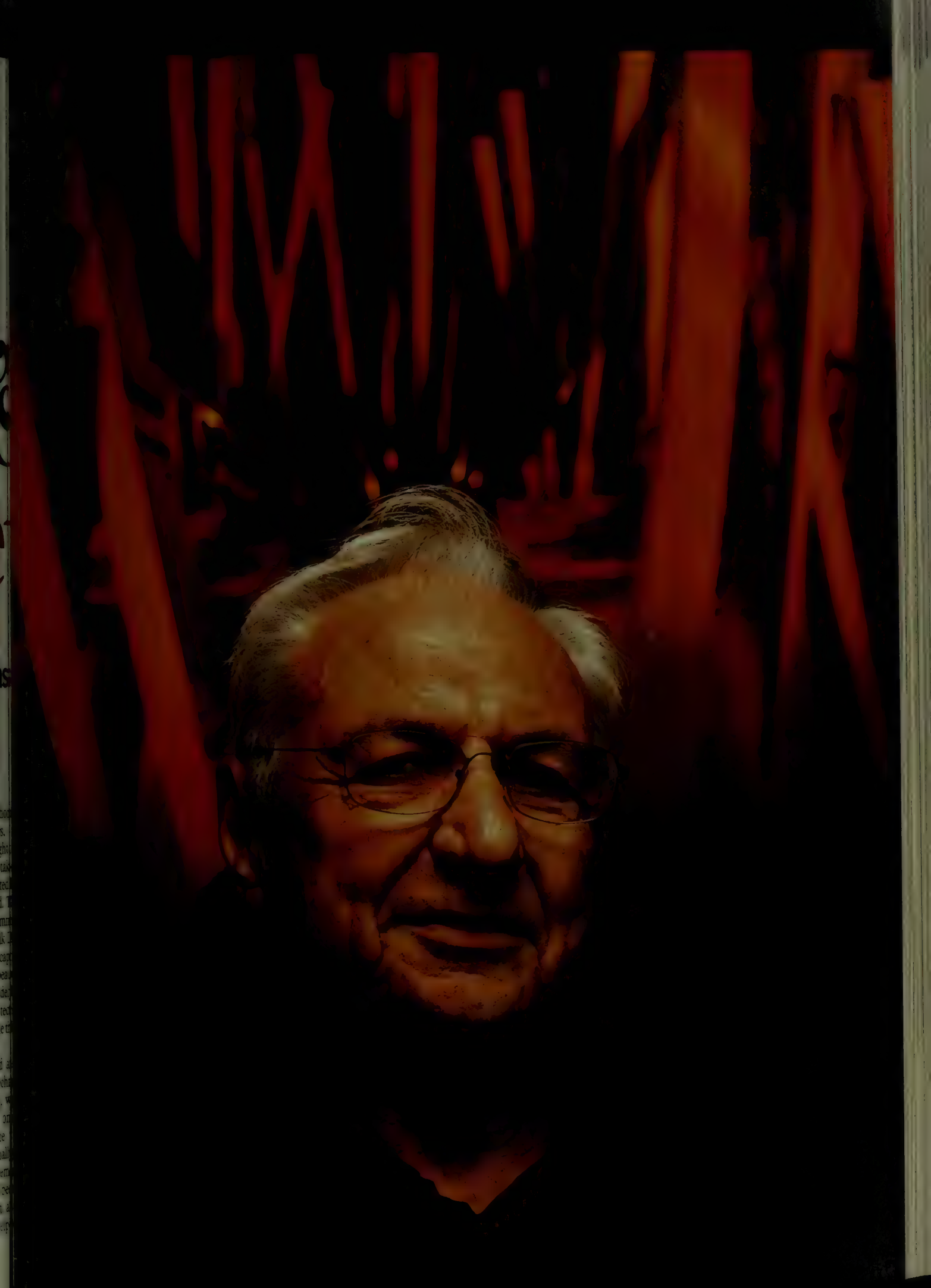
Petals

The Walt Disney
Concert Hall
in Los Angeles

one of this consequence, the relationship among architects, contractors, and clients is difficult, if not downright contentious. The buildings usually take longer to complete than expected and cost much more than calculated. There may be no other encounter of commerce and art that is as awkward. Frank Wright, an imperious figure in capitalism, was famous for building beautiful but unlivable homes. Gehry, widely regarded as one of the finest architects on the planet, is a pragmatic man. He thinks it doesn't have to be that way.

That's where the 74-year-old architect's new business, Gehry Technologies, comes in. The enterprise, which launches this month, builds on the firm's 13 years of experience

CATIA, a design software originally developed for the aerospace industry by Dassault Systemes in France. Years ago (but not long enough ago to have been in full use in designing the Disney Hall), James Glymph, a senior partner at Gehry's firm, was looking for a way to help







Flowing

(clockwise from top) The business school at Case Western Reserve University; the Vitra furniture factory and chair museum in Germany; the main stage of the Disney concert hall, new home of the Los Angeles Philharmonic; and the Guggenheim Museum in Bilbao, Spain

tractors better understand the demands of Gehry's increasingly complicated designs. He chanced upon an aerospace engineer who recommended the CATIA software; the computer programmers on Gehry's 130-person staff have since modified it for architectural work. Now the software brings Gehry's curvy roofs and walls to life in three dimensions: After he designs his buildings, still using just cardboard, wood, and paper, a specially developed tool traces his

models and translates them into 3-D images.

Perhaps more crucially for other architects, the software can also be used by contractors to produce exact measurements of the steel, wood, and other materials needed in a project. By linking dozens of such suppliers on a single software platform, the construction of complex buildings becomes vastly more efficient. "They have reconceived the process of construction," says William Mitchell, a longtime Gehry collaborator and dean of the school of architecture at Massachusetts Institute of Technology, which hired Gehry to design a computer center that is now under construction. Gehry Technologies was formed to provide training to architects who buy the software and related programs, and the firm will work with IBM to market CATIA. "We couldn't do what we do without it," says the architect, who doesn't actually use a computer himself.

While he's at it, Gehry would also like to see more cooperation between architects and contractors. In many cases, architects hand over designs to builders, who often prefer to have as little contact as possible with them thereafter. Some contracts even prohibit architects from going to construction sites. This, they say, is the best way to prevent the architects from trying to make expensive changes, the cost of which is borne by the construction company. Gehry, however, works with the builders and contractors to cement, so to speak, the design and budget early on. "We spend a lot more time with the subcontractors so when we get to the final drawings, we solve most of the technical problems," Gehry says. "You know where you are going before you start construction, so you minimize the surprise from the owner's standpoint. You get all the bad news up front."

Looking for a Hero

TO MOST PEOPLE, GEHRY WILL ALWAYS be known as the architect who found a way to spectacularly subvert the modernist box that is the foundation of most buildings, to combine the abstract with the ordinary in a way that is entirely functional. Until now, the Bilbao Guggenheim has been the most famous expression of this vision. But to Gehry, technophobe though he is, his innovations to the process itself are nearly as important. "I think it could have more of an impact," he says. "That's my lefty do-gooder side."

Gehry grew up in Depression-era Canada, playing with broken toasters and clocks in his grandfather's Toronto hardware store; he built imaginary cities with spare parts. His father, a struggling businessman seeking a better life, moved the family to Los Angeles when Gehry was 17. There, Gehry installed prefabricated breakfast nooks in houses by day and studied fine arts at the University of Southern California at night. But after observing the flamboyant California architect Raphael Soriano at a construction site, Gehry switched his focus to architecture. "I

(CLOCKWISE FROM TOP) PHOTOGRAPHS BY GRANT MUDFORD; JEFF GOLDBERG/ESTO; HECTOR MATA/AFP/GETTY IMAGES; RICHARD BRYANT/ESTO

came from a very poor family. I didn't have any hope of anything," Gehry says. "You're always looking for a hero, and he was very heroic."

After graduating in 1954, Gehry made a modest living designing small office buildings, shopping centers, and other commercial structures. He came to appreciate the work of such modern artists as Robert Rauschenberg and Edward Kienholz, who assembled works out of objects they found on the street. In the late 1970s, he expanded his own simple Dutch Colonial home in Santa Monica using chain-link fencing, corrugated steel walls, and exposed wooden beams. His neighbors hated it—one used to take his dog to relieve itself on the property. Even today, those who criticize Gehry's work contend that his buildings often clash with their surroundings. But the house generated plenty of international attention. "I wasn't trying to make a statement," Gehry says. "I had \$50,000 to do it. We had a kid and we needed a bedroom." But the public reaction, both pro and con, inspired him. "I thought, 'There's an aesthetic leap here,'" he says. "Why not turn cheap construction into a positive?"

Many Masters

IN 1987, LILLIAN B. DISNEY DONATED \$50 million for a new state-of-the-art home for the Los Angeles Philharmonic, and Gehry competed for the project against 24 other architects. At the time, he seemed an unlikely choice: One civic leader told the selection committee that "we can't have a chain-link, plywood, corrugated-metal concert hall." But others familiar with the range of Gehry's work prevailed, and he was officially selected in December, 1988.

Disney Hall would prove to be a project with many masters. Los Angeles County, which owns the land, wanted the complex to include a parking garage (which it does) and a hotel (which it doesn't) to bring in more revenue. The Philharmonic pushed for more sophisticated acoustic features and more space: The walls and ceiling of the hall became sweeping and curved to create more "reverb points," and the backstage became wider to accommodate visiting orchestras and their equipment.

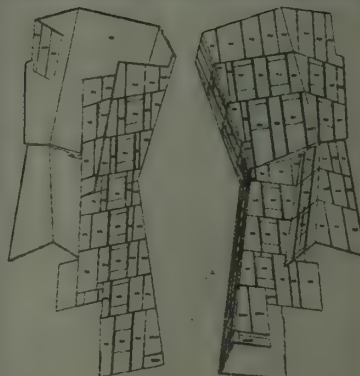
But an outside architect, hired to complete the final drawings since Gehry's small firm couldn't, had difficulty keeping up with Gehry's increasingly complex designs. Then the Northridge earthquake struck in early 1994, necessitating a complete redesign to meet new building-code standards. Each change brought higher cost estimates from the building's contractors. By December, the project, originally intended to be funded almost entirely by Lillian Disney's \$50 million gift, had escalated to more than five times that. Disney Hall ground to a halt.

Then a funny thing happened. The Gehry-designed Guggenheim museum in Bilbao, Spain, began attracting international acclaim even before it was finished. The swooping steel structure, begun after the Disney Hall and constructed with the latest CATIA software, was hailed as a triumph of modern architecture when it opened in 1997. It was completed on time and on its \$100 million budget.

Los Angeles leaders, embarrassed that an unassuming city such as Bilbao could succeed where they hadn't, renewed their efforts to complete Gehry's building. Then-Mayor Richard J. Riordan enlisted the help of local businessman and philanthropist Eli Broad. More contributions came from the Disney family and Walt Disney Co., as well as other corporations and individuals. After learning that the committee in charge of the project wanted to hire another architect to finish the work because of all the delays, Gehry submitted a letter of resignation. In the end, Lil-

A Clearer View

Gehry creates his unique buildings, like this computer center under construction at MIT, using modeling software called CATIA. His new firm, Gehry Technologies, will teach architects and contractors to use it.



1 Most architectural drawings are two-dimensional, which, of course, doesn't really capture the depth of the structure.



2 Three-dimensional design software, like the kind Gehry uses, helps builders and suppliers better understand the amount of material required and how all the complex pieces fit together. That, in turn, helps them price their services more accurately.



3 The result is buildings that benefit from some of the same time and cost advantages as those created with mass-produced construction materials.

Data: Skanska USA Building Inc.

lian Disney's daughter, Diane Disney Miller, insisted that he stay on. When he returned to the project, Gehry and the contractors used CATIA to determine more accurately the cost of the steel, exterior metal, glass, and woodwork.

Today, at a final price of \$274 million, Disney Hall is regarded as a masterpiece. The Los Angeles Philharmonic is the hottest ticket in town, and the building is already a destination.

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for tourists. "Frank has done it again," says Mark Wigley, interim dean of the Graduate School of Architecture, Planning & Preservation at Columbia University. "He sings to us with metal and wood. Believe it or not, wonderful buildings can be built in the U.S."

Gehry has since been putting his software and collaborative process to good use on other big projects: the Peter B. Lewis building at Case Western Reserve University, which is home to the business school and opened a year ago, and the Ray & Maria Stata Center at MIT. The architect's detailed information on even the most complicated parts of the computer lab has kept the project within the final \$300 million budget. L. William Zahner, president of the company that created the steel fabrication for the lab, says: "If I could buy stock in Mr. Gehry's firm, I'd do it." At Case Western, the general contractor, Hunt Construction Group Inc. of Phoenix, and the subcontractors all used CATIA to place their bids. As a result, even though the size of the business school increased during the design process, the building was finished on time and just 2% over the final budget of \$62 million. Hunt is now using the software for a Gehry-designed science center that is under development at Princeton University.



Pragmatic
Gehry's plywood, corrugated-steel, and chain-link home in Santa Monica, Calif.

The person who have been most pantly surprised by business school's sp and economical struction could be B. Lewis himself. in the 1980s, L then the chief exec of insurance giant gressive Corp., I Gehry to design an tion to his house decade later, Gehry Lewis had instead ceived of an \$80 mi

estate—which Lewis eventually decided was too great a extravagance. He now lives on his yacht half the year. But Gehry experiments with metal helped inform his design of the B museum (Lewis is chairman of the board of the Guggenhe and they both jokingly refer to Gehry's \$5 million tab for L place as his own genius award.

So it is with years of experience, some chagrin, and satisfaction that Gehry says: "People don't want to go gro in the fog, they want to know what they're into. That's we are trying to do." It's hard to imagine Frank Lloyd W saying that. ■

—By Christopher Palmeri in Los An

BIO

Frank Owen Gehry

In Depression-era Canada, young Gehry built "cities" from spare parts



BORN Feb. 28, 1929, in Toronto

EDUCATION Bachelor of Architecture degree, University of Southern California, 1954; dropped out of Harvard's graduate school of design after one year in 1957.

POSITION President, Gehry Partners, based in Marina del Rey, Calif.

SOURCES OF INSPIRATION Tries to instill motion in stationary objects, citing sources as diverse as Indian Shiva sculptures and the carp his grandmother bought to make gefilte fish.

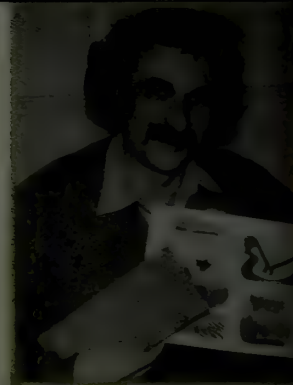
MOST FAMOUS BUILDING The 1997 Guggenheim Museum

in Bilbao, Spain. Increase in tourism dubbed "the Gehry effect."

MOST NOTORIOUS DESIGN Remodeled family home in Santa Monica with chain-link fence and plywood in the late 1970s. The neighbors hated it.

FIRST CURVY BUILDING The 1989 Vitra furniture factory and museum in Germany.

ONE SECRET TO HIS SUCCESS Gehry uses design software called CATIA that brings his complex drawings to life and allows contractors to produce exact measurements of the materials needed.



LITTLE-KNOWN FACT Gehry used to play hockey regularly and has hired many junior architects who also like to get out on the ice.

FAMILY Two daughters with first wife, Anita, who asked him to change his last name from Goldberg. Two sons with current wife, Berta, who serve as the Gehry firm's chief financial officer.

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Zooming In on Digital Zooms

Panasonic and Olympus offer the the best of a growing list of choices. **BY LARRY ARMSTRONG**

IT MUST BE THE PAPARAZZO IN ME, but I've always been a sucker for a camera with a zoom lens. A big one. A lens that can bring distant subjects breathtakingly close, magnifying your snapshots—surreptitiously obtained or not—10 times or more. In the analog age, I was the one walking around with a telephoto lens bigger than the camera itself. It was heavy: You needed one hand to hold the camera and the other to support the lens. That all changed with digital photography: Because you're exposing

a small, electronic sensor instead of a 35mm expanse of film, the big optics can come small and compact. But until last summer, there wasn't much choice. Olympus, Hewlett-Packard, and Panasonic had consumer models, priced in the \$400-to-\$600 range. I set out to explore what I figured was an intriguing niche in the digital camera market. Within a month, however, four companies—Kodak, Fuji, Minolta, and Toshiba—introduced their first 10X optical zoom



PALIO IN SIENA
Where's Elvis?

The Crowded Field

Here are some promising contenders

Fujifilm

FinePix S5000

PRICE \$500

ZOOM LENS 10X

RESOLUTION 3.1 megapixels

PROS & CONS Attractive SLR lookalike, but image quality could be better



Hewlett-Packard

Photosmart 945

PRICE \$550

ZOOM LENS 8X

RESOLUTION 5.1 megapixels

PROS & CONS Has clever features—camera is bulky, and zoom motor is



Tastes of
the islands

147 An upbeat quarter
for fund investors

154 How to estimate
enterprise value

160 Barker: Steer clear
of Applied Materials



as. With nine new ultra-zoom
s so far this year, I couldn't keep up,
managed to look at five.
show you the flexibility you can get
a big zoom lens, consider what I've
with these cameras. I took pictures
formers on the stage of the Holly-
Bowl from my seat in the nosebleed
n. I grabbed a shot of a friend's
e hideaway from New Brunswick,
s an inlet of the Bay of Fundy. I put
her a series of close-ups—suitable

for framing—of butterflies, all shot with
no chance of scaring them away. There's
no way that you could do any of that with
a wimpy 3X zoom camera.

My favorite cameras turned out to be
two I started out with, Panasonic's Lumix
DMC-FZ1, around \$400, and the Olym-
pus Camedia C-740, about \$450. (Retail
prices can vary by \$100 or more, so shop
carefully.) These models are the most
compact of the bunch: Unlike the others,
they can be carried in a coat pocket. They

feel the sturdiest, too, with snap-shut
doors instead of rubber flaps to cover all
the hidden connectors.

My choice of the Panasonic surprised
me. The company isn't known for its dig-
ital cameras. At 2 megapixels, the FZ1 has
the lowest resolution in the category. And
it's a point-and-shoot only camera: There
are no manual controls for a more serious
photographer. If you want control over
the shutter speed and aperture and
enough resolution to print an 8-in.-by-10-
in. glossy, choose the equally-compact
Olympus C-740—which inexplicably has
no ability to record sound for video clips
or to narrate your still photos—or that
company's C-750, a 4-megapixel ultra-
zoom model that costs about \$100 more.

But the Panasonic has a 12X lens, the
biggest zoom on the market, and that lens
is made by Leica, the gold standard for
camera optics. It's also the only lens on a
digital still camera that is optically stabi-
lized to compensate for any movement
while you're taking the picture. That's im-
portant, because it's difficult to hold a
camera steady enough to use a long lens
at its full range without giving your snap-
shots the jitters—professionals say you
should wait to squeeze the shutter be-
tween heartbeats. The feature gives the
Panasonic a definite edge in situations,
such as twilight telephoto shots or at dim-
ly lit parties, where the other cameras
would require a tripod.

PICK OUT THE FAVORITE

THE FUJIFILM, KODAK, AND HP cam-
eras are styled to mimic traditional sin-
gle-lens reflex cameras, with a big right-
hand grip. In my opinion, Kodak goofed
by putting the grip too close to the lens, in
an effort to make the camera smaller. I
couldn't get my fingers between the grip
and the lens, and the camera never felt se-
cure in my hand. The slightly larger Fuji
model, with its rubberized coating, felt far
more balanced and comfortable. Another
advantage: It can take conventional AA

K
are DX6490
500
ENS 10X
TION 4.0 megapixels
CONS Hard to get a grip on this
se fine model



Olympus
Camedia C-740

PRICE \$450
ZOOM LENS 10X

RESOLUTION 3.2 megapixels

PROS & CONS Pioneering ultrazoom
camera now is behind the curve



Panasonic
Lumix DMC-FZ1

PRICE \$400
ZOOM LENS 12X

RESOLUTION 2.0 megapixels

PROS & CONS The only big zoom with
image stabilization



(TOP) PHOTO-ILLUSTRATION BY MICHEL TCHEREVKOFF

batteries or rechargeables, rather than a proprietary one such as Kodak uses.

Although I've never been a fan of HP cameras—they're big, boxy, and slow to record images—the new top-of-the-line Photosmart 945 is HP's best effort so far. This one has some nifty features I wish other camera makers would adopt. Its display neatly clears up any confusion between optical and digital zoom. In the optical mode, it shows the subject getting

closer as you zoom in on it. But when you use digital zoom, which kicks in when the optical zoom reaches its limit, the camera simply crops the edges of the picture to blow up the center. You can't see this happening in most cameras' displays, but HP uses a yellow frame to show how much of the picture you lose as you zoom in.

All of the cameras have a flash that you have to pop up manually. And all of them have an electronic viewfinder instead of

an optical one: The HP and Fuji m have a light on the front that helps autofocus do its job even in the dark. A nice touch.

You'll find these cameras a lot of whether you're a soccer parent wanting to pick out your star halfback from the bleachers or whether you just want a camera with a little more photographic versatility when you're composing your snapshots. In any case, you'll always be ready for your close-up. ■

Food

Next-Generation Jerk

Jamaican cuisine has evolved as it has spread. **BY GERRY KHERMOUCH**

A WONDERFUL CULINARY breeze has been blowing in from Jamaica. The depth of Jamaican cuisine should be no surprise given the tropical fruits, vegetables, and spices that emerge from the Caribbean island's rich volcanic soil. The result has enlivened restaurant menus and given Americans new seasonings to zest up ordinary meals.

When you mention Jamaican cooking, you're talking first and foremost about the spicy, pit-barbecue style called jerk. The method of preparing meat with a dry rub, using scorching-hot Scotch bonnet peppers, was developed by runaway slaves to spice up the wild boars they chased down while hiding in the Blue Mountains. Over the centuries, the recipe picked up other peppers, garlic, paprika, wild cinnamon, and allspice. But only recently has the intensely aromatic jerk mixture moved off the streets and into restaurants. Even in Jamaica, "it only just hit the dining table in the past 20 years," says Virginia Burke, marketing director of the Walkerswood line of seasonings and

author of *Walkerswood Caribbean Kitchen* (Simon & Schuster).

Lately, chefs have been finding more varied ways to use jerk seasoning—for sushi, alligator, or sweet potato fries. The Ortanique restaurants, in Coral Gables, Fla., Washington, and Las Vegas, even serve jerk-rubbed Hudson Valley foie gras.

Meanwhile, Jamaican cuisine in general has been getting lighter and more healthful, relying less on coconut oil and starchy yams, cassava, and breadfruit. Jamaican cooks have rediscovered their native tangy fruits, including ackee (the reddish-yellow fruit of an evergreen tree), carambola (or star fruit), and ortanique (a cross between an orange and a tangerine).

FROM THE SOURCE

IN THE U.S., JAMAICAN-INSPIRED dishes are popping up in restaurants everywhere. At the high end, you can't do better than Ortanique. More mainstream, the Hops Grillhouse & Brewery chain of 74 brew pubs, mainly in the Southeast, has a Jamaican chicken marinated in pineapple, ginger, and soy. Darden Restaurants' 30 Bahama Breezes are also



BLACK GROUPE
At Ortanique's
three restaurants

popularizing West Indian cool.

Cities with a major Jamaican population, such as New York and Toronto, have the most authentic food. One favorite in Manhattan's Chelsea district is N (212 807-6411). Its intensely spiced dishes led one diner to swear in the *Zagat* guidebook that "they could jerk my ass and I'd eat it." Brooklyn's Boerum neighborhood boasts the store Brawta Caribbean Café (718 855-5444). In Toronto, check out The Real Jerk (463-6055).

For those who'd like to try Jamaican cooking at home, many upscale grocers carry the Jamaica-grown Walkerswood and Busha Browne's seasonings. Keep in mind that Jamaican cuisine doesn't have to be scorching. Just keep a light hand on that bottle of jerk sauce. ■

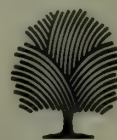


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Mid Turmoil, Funds Take Off

During the third quarter, equities rallied from the storm. **BY LEWIS BRAHAM**



POSITIVE RETURNS may be the one saving grace for mutual funds this year. State and federal regulators' probes of trading practices at such fund giants as Janus and Nations Funds have mired the industry in its worst scandal in decades, but all markets tend to sweep a lot of

nastiness under the rug.

Across the board, equity funds have rallied, and bond funds have held their own despite a rise in interest rates. The average diversified U.S. stock fund is up 9.4% in the third quarter (through Sept. 19) and 24.1% this year, beating the Standard & Poor's 500-stock index's 6.7% and 19.2%, respectively. International stock funds have done even

better, up 11.9% this quarter and 24.2% for the year, thanks to rallies overseas—even in the long-suffering Japanese stock market.

Whether the bull market will last remains to be seen, but one thing is certain: Investors' appetite for risk has returned. In August, for instance, stock funds received \$26 billion in new cash, the third-largest monthly inflow in three years. Meanwhile, all of the most volatile funds are topping performance charts. Even technology and emerging-market funds are back in vogue.

Those who flocked to blue chips with pristine balance sheets during the bear market are now betting that improving business conditions will lift the fortunes of smaller, weaker companies. "Lower-quality stocks of companies without earnings and higher debt have performed better than higher-quality ones this year," says John Montgomery, portfolio manager of Bridgeway Ultra Small Company Fund. "That's typical during the early stages of an economic recovery."

Montgomery doesn't invest in debt-ridden or troubled companies, but he does buy tiny ones, which have a higher risk of failure but also a greater prospect for explosive returns than blue chips. Given investors' renewed predilection for risky fare, his fund has been a top performer, up 69.7% this year. So have a number of other small- and mid-cap funds, which continue to be popular with investors, receiving \$8.3 billion in new money this August, according to fund tracker Lipper. Meanwhile, large-cap funds lost \$900

ANDERS WENNGREN

Best-Performing Equity Funds

	TOTAL RETURN*	FUND	TOTAL RETURN*
Fidelity Semicond. Ultra. Inv.	52.39%	Rydex Electronics Inv.	29.34%
Fidelity Gold & Precious Metals S	46.68	iShares Goldman Sachs Semicon. Idx.	29.32
Fidelity Ultra Japan Inv.	41.35	Matthews Asian Technology	29.28
Fidelity Global Inv. World Prec. Minerals	37.64	Winslow Green Growth	29.27
Fidelity Technology Value	37.14	Van Eck Intl. Investors Gold A	29.13
Fidelity Japan	35.97	iShares Goldman Sachs Netwkg. Idx.	28.72
Fidelity Ultra Small Cap Inv.	34.71	Oberweis Emerging Growth	28.63
Fidelity Technology	33.83	American Heritage	28.57
Fidelity Japan Fund S	32.58	Evergreen Precious Metals Holdings I	28.23
Fidelity Global Inv. Gold Shares	32.48	ICON Information Technology	28.10
Fidelity Precious Metals & Minerals	32.43	Emerald Select Technology A	27.84
Fidelity Precious Metals Ultra. Inv.	32.35	AXP Precious Metals A	27.66
Fidelity Technology Value	32.12	Gabelli Gold	27.57
Fidelity UltraOTC ProFund Inv.	32.01	Ameristock Focused Value	27.38
Fidelity Internet	31.95	Tocqueville Gold	27.25
Fidelity Dynamic Velocity 100	31.71	Turner New Enterprise	27.25
Fidelity Emerging Growth Instl.	31.64	Firsthand Technology Innovators	27.10
Fidelity Internet Age	31.63	Reynolds Opportunity	26.99
Fidelity Large Cap Japan	31.25	Navellier Perf. Aggress. Micro Cap	26.97
Fidelity Rheinier Gold & Spec. Minerals A	31.06	Fidelity Japan Small Co.	26.87
Fidelity Open	30.24	Dreyfus Founders Passport F	26.78
Fidelity Information Age	29.98	Oppenheimer Emerging Growth Y	26.63
Fidelity Weis Micro Cap	29.37	PBHG Emerging Growth	26.52
Fidelity mbia Technology Z	29.36	Fifth Third Technology Inv. A	26.47
	29.34	Fidelity Advisor Electronics A	26.41

*30-Sept. 19, 2003. Appreciation plus reinvestment of dividends and capital gains before taxes

Data: Standard & Poor's

WHO SAYS THE SMART AND

ATTRACTIVE ONES ARE ALL TAKEN?



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Worst-Performing **Equity Funds**

FUND	TOTAL RETURN*	FUND	TOTAL RETURN*
ProFunds UltraShort OTC Inv.	-27.83%	AXA Rosenberg U.S. Lg./Md. Lng./Shrt.	-3.27%
Rydex Dynamic Venture 100	-27.74	INVESCO Energy A	-2.94
Rainbow	-16.39	Fidelity Select Natural Gas	-2.71
Frontier Equity	-16.13	iShares DJ US Telecomm. Sector Index	-1.91
Potomac Small Cap/Short Inv.	-15.55	Select Sector SPDR Healthcare	-1.84
Potomac OTC/Short Inv.	-15.40	Van Wagoner Mid Cap Growth	-1.70
ProFunds Short OTC Inv.	-14.93	AXA Rosenberg Global Long Short	-1.69
ProFunds Short Small Cap Inv.	-14.78	Van Wagoner Technology	-1.62
Rydex Arktos Inv.	-14.43	ProFunds Utilities UltraSector Inv.	-1.61
Rydex Dynamic Tempest 500	-13.10	Scudder Retirement IV	-1.58
ProFunds UltraBear Inv.	-12.98	AMIDEX 35 Mutual A	-1.57
Leuthold Grizzly Short	-9.95	Fidelity Utilities	-1.53
Comstock Capital Value R	-9.51	Van Wagoner Post Venture	-1.52
ProFunds Pharma. Ultrasector Inv.	-8.13	Franklin U.S. Long Short	-1.51
Potomac Dow 30/Short Inv.	-7.66	Scudder Target 2011	-1.49
Comstock Strategy O	-7.39	Howard Capital Appreciation	-1.42
Potomac US/Short Inv.	-6.91	Rydex Energy Inv.	-1.32
ProFunds Bear Inv.	-6.73	Select Sector SPDR Utilities	-1.31
Rydex URSA	-6.57	Scudder Target Equity 2012	-1.24
Rydex Energy Services Inv.	-6.49	Scudder Target 2010	-1.23
Fidelity Select Energy Service	-5.90	Fifth Third Strategic Income Instl.	-1.22
Centurion Counsel Market Neutral C	-5.85	Fidelity Select Utilities Growth	-1.19
AXA Rosenberg Value Lng./Shrt. Eq. Inv.	-4.68	ING Principal Protection 2 Q	-1.18
Smith Barney Telecomm. Income	-3.97	ING Principal Protection 3 Q	-1.17
Oppenheimer Real Asset Y	-3.94	Vanguard Wellesley Income Admiral	-1.15

* June 30–Sept. 19, 2003. Appreciation plus reinvestment of dividends and capital gains before taxes.

Data: Standard & Poor's

million, while funds that invest in stocks of all sizes received \$6.5 billion.

GROWTH IS BACK

ANOTHER SIGN OF a bull market is the resurgence of growth funds, which are big investors in tech stocks. "We're doing well because we stayed the course," says Jim Oelschlager, manager of White Oak Growth Stock Fund. "When stocks such as Juniper Networks, Applied Materials, and Intel were getting pounded last year, we held on to them." His fund, which has 61% invested in tech stocks, is up 42% in 2003, vs. 21.6% for the average large-cap growth fund.

Tech-fund managers have a more discriminating view. "You can't just round up the usual suspects and buy them," says manager Kevin Landis of Firsthand Technology Value Fund, which soared 32% this quarter. Landis is referring to big tech companies such as Oracle and Sun Microsystems. He thinks there are attractive plays in the consumer-electronics and tech-consulting sectors. That's because consumers still want the latest in digital cameras, cell-phone cameras, MP3 players, and video games. As the U.S. government beefs up security in the post-

September 11 world, IT consultants Caci International and Anteon have won lucrative long-term contracts, he adds.

One surprising rally is in precious met-

als funds, which were up an average 10% this quarter. Traditionally thought of as defensive investments, gold stocks typically zig when the market falls. Some gold-fund managers contend the ongoing strength in the yellow metal is a sign that investors believe the market won't last and are trying to hedge their bets. "There are so many heads facing this economy," says Darko Manovic, manager of Scudder Gold & Precious Metals Fund, up 46.7% this quarter. "Consumer and federal debt are at high levels, unemployment remains high, and the trade deficit is enormous."

Others, such as Caesar Bryan of Columbia Gold Fund and John Hathaway of Queville Gold Fund (page 151), think the government's attempts to stave off a recession—through interest-rate and tax cuts—have created an environment that is good for gold and the stock market. Gold prices, like other commodities, usually rise with inflation. So the strong and monetary stimulus is a positive sign for gold investors.

OVERSEAS SURGE

OVERSEAS, BULL RUNS in Asia have buoyed foreign stock funds. The region has benefited from the consumer-driven recovery in the U.S., as it's the largest exporter of consumer electronics. Japan, in particular, seems to be awaking from its 13-year bear-market slumber. "A flood of stronger-than-expected earnings and economic data has been coming out of Japan this year," says George O.

Healthy Signs At **Equity Funds**

CATEGORY	TOTAL RETURN*	CATEGORY	TOTAL RETURN*
Precious Metals	26.97%	Financial	8.1
Japan	24.52	Mid-cap Value	8.1
Technology	19.87	Communications	8.1
Diversified Pacific/Asia	18.96	Large-cap Growth	8.1
Pacific/Asia ex-Japan	16.53	Health	7.1
Small-cap Growth	16.42	International Hybrid	6.1
Diversified Emerging Markets	14.83	Miscellaneous	6.1
Latin America	14.43	Large-cap Blend	6.1
Small-cap Blend	13.84	Large-cap Value	5.1
Small-cap Value	12.76	Domestic Hybrid	4.1
Mid-cap Growth	11.19	Natural Resources	3.1
Foreign	11.17	Utilities	0.1
Mid-cap Blend	10.83		
World	10.21	International Equity Funds	11.1
All Cap	10.01	Equity Funds	9.1
Europe	8.56	U.S. Diversified Funds	9.1
Real Estate	8.41	S&P 500	6.1

* June 30–Sept. 19. Appreciation plus reinvestment of dividends and capital gains before taxes.

Data: Standard & Poor's

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How Big **Equity** Funds Fared

FUND	ASSETS (BILLIONS)	TOTAL RETURN*
Vanguard 500 Index Inv.	\$67.3	6.71%
Fidelity Magellan	63.3	5.48
Investment Co. of America A	52.4	5.59
Washington Mutual Investors A	49.0	4.39
Growth Fund of America A	41.3	8.24
Standard & Poor's Depository Rcpts.	34.9	6.29
Fidelity Contrafund	32.2	8.21
Fidelity Growth & Income	28.4	4.28
Income Fund of America A	26.7	3.87
New Perspective A	25.3	11.73
EuroPacific Growth A	25.0	12.42
Vanguard Wellington Inv.	21.8	3.15
Fidelity Low-Priced Stock	21.0	12.79
American Century Ultra Inv.	20.6	7.05
Fidelity Equity-Income	20.6	6.63
Fidelity Blue Chip Growth	20.4	6.91
Fidelity Growth Company	20.4	15.26
Vanguard Total Stock Market Index Inv.	20.3	7.91
Nasdaq 100 Index Tracking Stock	20.0	15.87

*June 30-Sept. 19, 2003. Appreciation plus reinvestment of dividends and capital gains before taxes.

Data: Standard & Poor's

manager of William Blair International Growth Fund. "What's primarily driving it is corporate restructuring." Manager Mark Headley of Matthews Japan Fund concedes that investors have a right to be skeptical after so many bad years. But he believes the recovery is for real this time. "Managers of Japanese companies are much more focused on profitability than they ever have been in the past," he says. "The old, inefficient system is dying."

The only disappointment this quarter

is currently 30% in cash.

One of the few bond funds to prosper this quarter is Rydex Juno, up 6.1%. This unusual fund shorts, or bets against, Treasury bonds. Its assets have grown eightfold, to \$800 million, since January. That's a good sign investors think there is more downside in bonds.

Still, most investors pin their hopes and aspirations on equities. As long as those funds are prospering, they can shrug off the decline in bonds. ■

has been bond funds. They've fallen 0.6%, on average, as interest rates have edged higher. And from the look of it, more bad news is coming. "A 4% yield on a 10-year Treasury bond will not be enough compensation for investors going forward if inflation picks up," says Tad Rivelle, chief investment officer at Metropolitan West Asset Management, which manages \$14 billion in bonds. Bond funds saw \$15.3 billion in shareholder sales this August, their largest monthly outflow in more than two decades. Apparently, fund investors agree with him.

Any indications that the economy is in full recovery mode will cause a further sell-off. So Rivelle is favoring high-yield bonds, which are yielding a more attractive 9% on average. But some managers say even high-yield bonds are no longer cheap. Manager Thomas Atteberry of FPA New Income Fund has been reducing his high-yield position and

Q&A

Where Is Gold Going



How much higher can it rise? Quite a bit, believes **JOHN HATHAWAY**, portfolio manager of the Tocqueville Fund. Pers. finance wr

Lewis Braham recently caught up with Hathaway at his New York

Where do you see gold heading?

More than \$400 an ounce in the year and near \$1,000 in the next years. Right now, it trades above \$340. From the mid-1980s to the mid-1990s, gold traded between \$340 and \$400, so \$400 gold is not a big deal.

What's driving the rally?

Supply and demand. Gold below \$300 an ounce does not justify new investment to maintain production at current levels. The largest mining companies are not replacing even the gold they sell every year.

What about on an economic

The macroeconomic climate is extremely favorable. Gold rises when inflation goes up and the value of currencies goes down. The U.S. government is doing everything it can to reflate the economy. It has cut interest rates to the bone and increased the money supply. With rates at historic lows, foreigners, who own 46% of the Treasury bond market, have less interest in owning Treasuries. If the dollar is selling, the U.S. dollar will fall and accelerate gold's rise.

What are your favorite stocks?

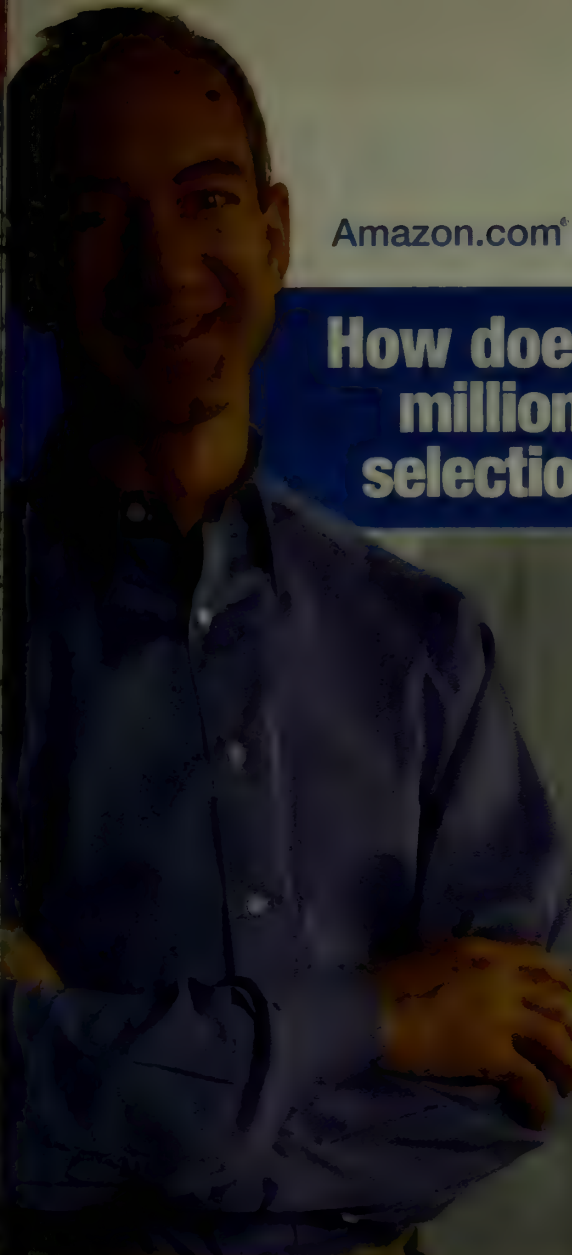
Our largest holdings are Newmont Mining, Gold Fields, and Hecla Mining. These are premier large-cap miners with solid balance sheets. We also own Placer Dome, an undervalued laggard that has growth prospects. Finally, we have a number of mid- to small-cap producers such as Golden Star Resources and IAMGold. These may become acquisition targets as gold's price rises and the industry looks to fill production gaps.

Most **Bond** Funds Take A Hit

CATEGORY	TOTAL RETURN*	CATEGORY	TOTAL RETURN*
Convertibles	4.89%	Muni. New York Long	-1.00%
Emerging Markets Bond	2.50	Muni. Single-State Intermediate	-1.01
High Yield	1.98	Muni. Single-State Long	-1.03
Multisector	0.44	Muni. National Long	-1.17
Muni. Short	0.10	Intermediate (General)	-1.28
Ultrashort	0.00	Intermediate Government	-1.30
Muni. High Yield	-0.34	Muni. California Long	-1.46
Short (General)	-0.39	Long (General)	-2.70
International Bond	-0.67	Long Government	-4.16
Short Government	-0.69		
Muni. National Intermediate	-0.85	Taxable Bond Funds	-0.33
Muni. California Intermediate	-0.86	Nontaxable Bond Funds	-0.94
Muni. New York Intermediate	-0.90	All Bond Funds	-0.62

*June 30-Sept. 19, 2003. Appreciation plus reinvestment of dividends and capital gains before taxes.

Data: Standard & Poor's



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The Power to Know.



A Better Way to Size Up a Company

Forget p-e ratios. "Enterprise value" can give you a clearer picture. **BY ROBERT BARKER**

INQUIRING INVESTORS QUICKLY run up against a serious limitation in the single most familiar tool used by stock analysts: the price-earnings ratio. Consider the current p-e's of two well-known rivals, J.C. Penney and Sears Roebuck. The other day, Penney's p-e was 19 and Sears' was 9.5. So buying stock in Penney must have been twice as costly as buying a stake in Sears, right?

If you doubt the utility of that conclusion, you're ready for a better way to size up companies and how their stocks are priced on Wall Street. It's called "enterprise value." Enterprise value, or EV for short, measures how much capital it would take to buy an entire public company. It can help you cut through a lot of the clutter—in the case of Sears and Penney, far different balance sheets—that can quickly render p-e ratios meaningless. "Enterprise value takes a broader view," says Peter Temple, a former securities analyst and author of a new book, *Magic Numbers for Stock Investors* (John Wiley & Sons, \$29.95). "You could have two different companies in the same industry, making the same profit, but one would have a lot of debt and the other none at all." By looking through the lens of enterprise value, he adds, "the company with no debt would look cheaper."

Enterprise value doesn't appear in such investment classics as Benjamin Graham's and David Dodd's *Security Analysis*, but the ideas behind it do pop up in some of Warren Buffett's early letters to investment partners. The term didn't appear in either *BusinessWeek* or *The Wall Street Journal* before 1991.

So, precisely what is enterprise value? Simply stated, EV is the sum of a company's stock market capitalization plus its

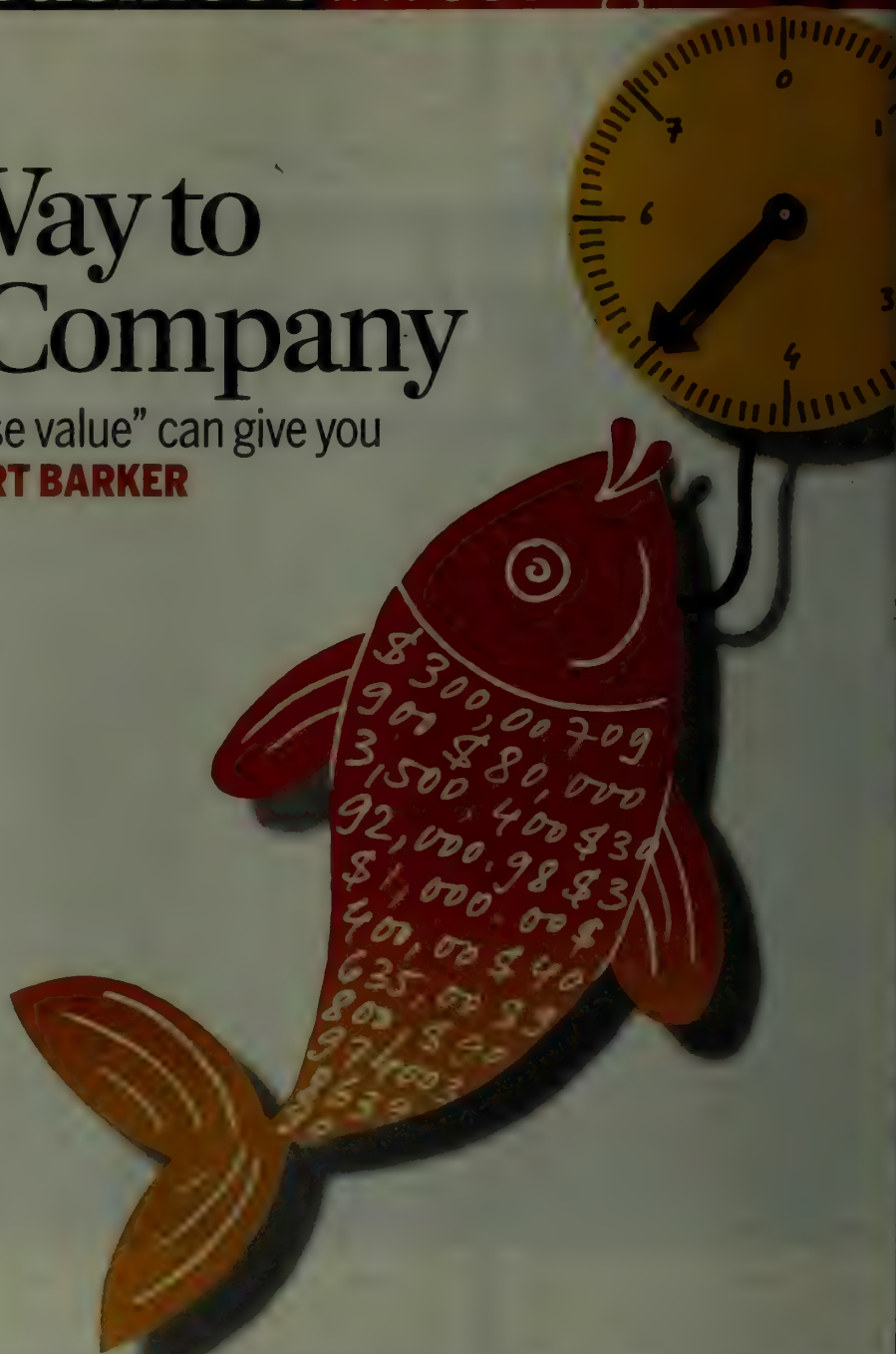
net debt. Stock market capitalization is a company's total shares multiplied by its stock price, and net debt is a company's total debt, minus its holdings of cash and marketable securities.

BUYING OUT DUPONT

IN THE DIAGRAM on page 156, you can see just how EV is derived from financial statements. Suppose you wanted to find the EV of chemical giant DuPont. What would it cost you to buy it out? First, you would have to pay for all of the company's shares. With the stock at \$41 and a billion shares outstanding, that comes to \$41 billion. Next, you would have to add in the debts you would be assuming by taking over the company. DuPont has \$5.9 billion in short-term debt, plus another \$5.5 billion in long-term debt—a total of \$11.4

billion. With ownership, however, you would also get control of DuPont's cash reserves, \$4.1 billion worth at last. In theory, then, you could use DuPont's cash to pay off part of its debt, leaving \$7.3 billion in net debt. Add that to DuPont's \$41 billion in total stock value, and you get \$48.3 billion. DuPont's EV, or how much capital an imaginary buyer would need to free and clear.

Unless you're rich as Croesus and can afford a shopping spree, knowing a company's enterprise value won't help you decide whether to buy. You can learn a lot more by comparing a company's EV to a measure of the company's earnings, such as a p-e ratio relates stock price to earnings. In this analysis, it's important to use earnings before interest and taxes, often called EBIT. The reason is that



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enterprise value assumes you've already paid off the company's debt and used its cash balances so there would be neither interest costs nor income.

BETTER BARGAIN

TO SEE HOW such a comparison might work, let's return to Sears and Penney. At \$45 a share, Sears has a stock market value of \$13.4 billion and a p-e ratio of 9.5. But because its balance sheet is laden with \$29 billion in net debt, its EV comes to \$42.4 billion, or nearly 13 times its \$3.3 billion in EBIT. By contrast, Penney at \$23 a share has a market value of \$6.2 billion and a p-e ratio of 19, twice as high as Sears's. But because Penney owes a lot less—its net debt is under \$3.2 billion—its EV comes to \$9.4 billion and its EV-to-EBIT ratio is just

9.8. Seen in this fuller way, Penney, not Sears, represent the better bargain.

Another helpful exercise is to turn these figures upside down. Dividing EBIT by enterprise value indicates the percentage return that a theoretical buyer of an entire company might see. This percentage is sometimes called the "cash return" or "cap rate" for "capitalization rate," depending on which of several alternative profit measures—EBIT, EBIT minus depreciation and amortization (EBITDA), or free cash flow—that an analyst chooses to use in the numerator. What's it good for? Hummingbird Value Fund's Paul Sonkin uses cap rates to separate potential investments from poor-returning companies. As Sonkin puts it, "This helps me answer the question: 'If I could own the whole thing, would I want to own the whole thing?'"

Going back to Sears and Penney, ney had the higher rate of return over past four quarters. Its EBIT of \$950 million divided by its \$9.4 billion in enterprise value makes a return on investment of 10.2%. Work the same numbers for Sears and the past year's return comes to 7.8%. Likewise, you might compare DuPont and its rival, Dow Chemical. The result: Dow in the past four quarters turned 3.7%, while DuPont saw 4.2%.

However enterprise value is used, its core strength is its ability to put companies with different capital structures on the same basis for analysis. What it does, of course, is foretell the future: How much will a company earn this year, next? Still, a rigorous application of enterprise value analysis will tell you how much the future profits are worth. ■

Adding Up Enterprise Value

To show how investors might use enterprise value to analyze a company, we chose DuPont. Our first task was to gather the chemical giant's most recent quarterly report, which can be found on its Web site. (Go to dupont.com, click on Investor Center, then SEC filings.) Next, we followed these steps:

1 In Note 7 of the income statement, look for the number of fully diluted shares in the most recent period. For DuPont, this was 1,000,066,463.

2 Find the stock's latest price—in DuPont's case, on Sept. 23, it was near \$41 a share.

3 Multiply the number of shares from Step 1 by the stock price in Step 2. This is the company's stock-market capitalization. DuPont's came to \$41 billion.

4 Now, turn to the company's latest balance sheet. Look under Liabilities to find any short-term borrowings, and add that to any long-term debt. This sum, total debt, for DuPont at June 30 was \$11.4 billion.

5 Under Current Assets, find cash and marketable securities. Subtract this figure, in DuPont's case \$4.1 billion, from total debt. The result is net debt, or \$7.3 billion at DuPont.

6 Add the company's market capitalization found in Step 3 (for DuPont, \$41 billion) to its net debt found in Step 5 (\$7.3 billion). This sum equals enterprise value. DuPont's came to \$48.3 billion.

Data: Company reports; BusinessWeek

Note 7. Earnings Per Share of Common Stock

Set forth below is a reconciliation of the numerator and denominator for basic and diluted earnings per share calculations for the periods indicated:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2003	2002	2003	2002
Weighted-average number of common shares - Diluted	1,000,066,463	999,146,015	999,131,870	1,000,197,623

Consolidated Balance Sheets (Note 1)

(Dollars in millions, except per share)

	June 30, 2003	December 31, 2002
Assets		
Current assets		
Cash and cash equivalents	\$ 3,926	\$ 3,678
Marketable debt securities	183	465
Liabilities and Stockholders' Equity		
Current liabilities		
Short-term borrowings and capital lease obligations (Note 10)	5,860	1,185
Income taxes	141	47
Other accrued liabilities	2,895	3,137
Total current liabilities	11,716	7,099
Long-term borrowings and capital lease obligations	5,497	5,847



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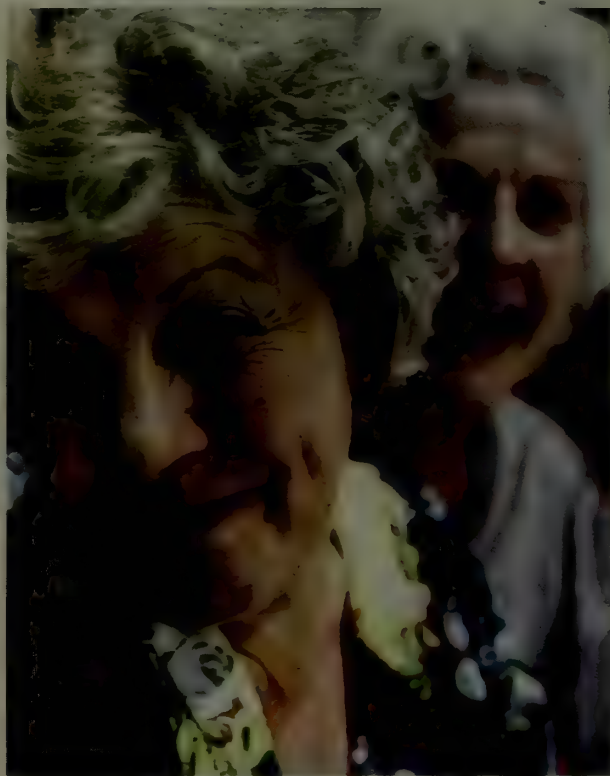
HEALTH

Marriage Dividend

WOMEN WHO WANT to live a long and healthy life can best increase their odds by acquiring—no, not exercise equipment—a spouse. A new study of women age 65 and older found that those with a longtime husband coped with the stresses of aging, clocked lower blood pressure readings, and had stronger immune systems than their single counterparts. **Married women with many friends did best of all**, living one to two years longer than their more isolated peers.

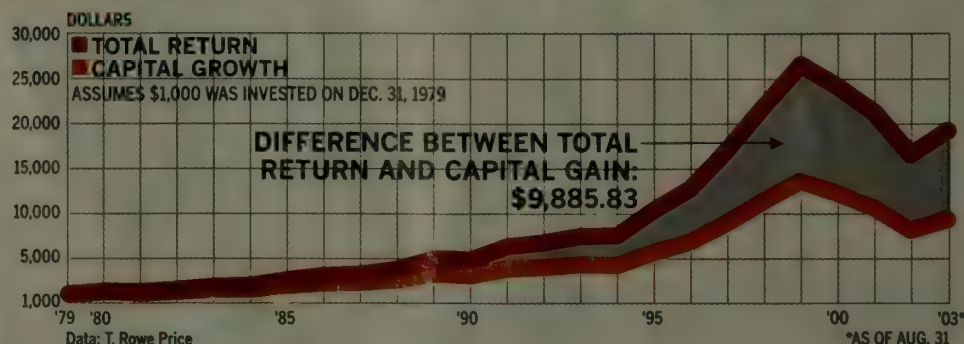
Thomas Rutledge, a psychologist at the University of California at San Diego, began surveying 7,524 women with an average age of 74 in 1986, then followed up six years later. By then, nearly 20%, or 1,451, of the women had died, 215 from heart disease. The study, which will continue until all the subjects have died, has found that women with strong social networks, and especially married women, were more likely to still be alive at the time of follow-up and to have less evidence of heart disease. This was true, the researchers said, even when they took into account other risk factors such as chronic illness, obesity, smoking, and depression.

—Catherine Arnst



IT ALL ADDS UP

MANY HAPPY RETURNS What's the real value of dividends? A lot. The return from **reinvested dividends** constituted more than 50% of the total return of the **Standard & Poor's 500-stock index** over the past 20-plus years (through Aug. 31, 2003).



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Memberships at other famous clubs in Britain have steep joining fees and annual dues of several thousand dollars (*BusinessWeek* Investor, June 23).



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BY ROBERT BARKER

Don't Get Hooked On Applied Materials

Long ago on a misty Mediterranean shore, there lived a mythical band that subsisted on the narcotic leaf of the Lotus flower. Today in America, descendants of the Lotus Eaters instead rob corner drugstores of OxyContin. Or, if they're capitalists, they trade dollars on NASDAQ for semiconductor stocks.

The rush of pleasure promised by chip stocks can be so intense that it's understandable why some investors, after so recently having endured the agony of withdrawal, are now back to craving ecstasy. As an example of semiconductor investing's two sides, there's no better stock than Applied Materials. The leading maker of big, expensive machines that create tiny, precious microchips, Applied Materials logged a total return through the 1990s of better than 7,000%. Crashing in the new millennium, it soon lost four-fifths of its market value. Lately, Applied Materials is flying again, hovering under \$20, up from \$10.26 a year ago.

RIISING OR FALLING? The question for investors today is whether Applied Materials is just warming up for another towering vault or has swiftly outrun its foreseeable prospects. There can be no question of the Santa Clara (Calif.) company's prowess. Its balance sheet, with cash and short-term securities enough to pay its debts almost eight times over, is pristine. Free cash flow, more than \$520 million in the past 12 months on sales of \$4.7 billion, is growing again. And Applied Materials has invested heavily to exploit the chipmakers' continuing switch to production of larger, 300-millimeter wafers. Just the same, if anyone expects me to buy the stock, please first pass the OxyContin.

The reasons begin with two stock market tales that, while hardly conclusive, should not be ignored. First is the untethered enthusiasm surrounding chip stocks generally. The Philadelphia Semiconductor Index, anticipating a cyclical

upturn for which there is yet scant evidence in the most recent reports of fresh orders, is up no less than 55% this year. Second, this warm atmosphere has lured NPTest, a semiconductor-equipment company recently sold by Schlumberger, to refile papers on Sept. 10 for an initial public offering. The deal had originally been planned for 2002 but was then delayed and ultimately canceled. Its revival signals that the market in chip stocks is once more welcoming enough that knowledgeable sellers are selling.

Most specifically worrisome about Applied Materials is Wall Street's amnesiac insistence on focusing on the company's recent pro forma results. Applied Materials doesn't use the discredited term "pro forma." It instead

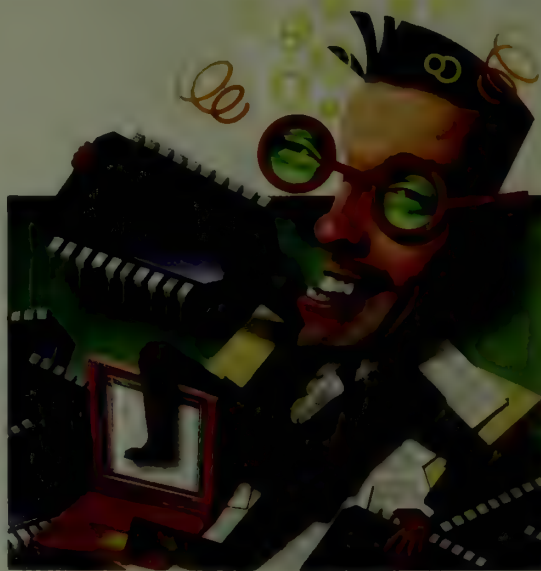
characterizes its profit after a variety of special charges as "ongoing basis" results. In any case, there is a stark difference between "ongoing basis" and actual: Through three quarters of this fiscal year, instead of the wide discrepancy disseminated "ongoing basis" profit of 8¢ a share, Applied Materials actually lost 10¢.

What's wrong with using "ongoing basis" results if they offer a clearer picture of the company's future? Nothing, except they carry the silent assumption that next year will suffer no more extraordinary write-offs. The consensus estimate of analysts for fiscal 2003 earnings is 46¢ a share. That would be quite a leap from the 13¢ in "ongoing basis" earnings analysts see for fiscal 2003, ending in October. Yet from last year's actual loss, 46¢ a share next

would prove an even bigger jump—a feat so incredible that bulls dare to dwell on it.

For kicks, let's say the chip business next year goes gangbusters. Let's assume that Applied Materials delivers the 60¢ a share in profit that is today's highest estimate on Wall Street. That means if you buy the stock today at \$20, you will have paid 33 times the coming year's profit. In October, 1998, investors in Applied Materials paid 19 times the earnings that eventually came in during that fiscal year. The stock in that time went up 159%. A year later, when the stock was poised to make a similar leap, investors still paid only 19 times the coming year's profit. Will someone please call the Betty Ford Center? ■

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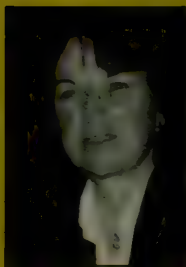
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Mark Edwards is Superintendent of Henrico County Public Schools in Richmond, Virginia, where he began the Technology & Learning Initiative, supplying wireless laptops to students and teachers and urging the entire education community, including parents, to understand and work with technology used in the classroom.



KATI HAYCOCK

Kati Haycock is a leading advocate for children and high achievement in the world of education. She is founder of The Education Trust, an organization dedicated to raising achievement among all students at all levels, especially those likely to be excluded from mainstream improvement efforts.



CAROL A. TWIGG, Ph.D.

Carol A. Twigg is Executive Director of the Center for Academic Transformation at Rensselaer Polytechnic Institute. The Center serves as a resource for colleges and universities, providing leadership in how effective use of information technology can improve student learning while reducing instructional costs.

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BY GENE G. MARCIAL

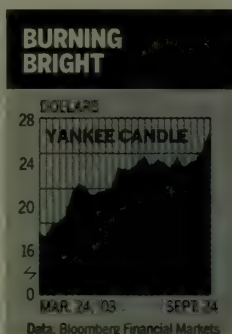
THE STEADY FLAME MAY ATTRACT SUITORS TO **YANKEE CANDLE**

A PROSTATE-CANCER DRUG FROM **DENDREON** SHOWS PROMISE

ACACIA TECHNOLOGIES GETS EVEN BIGGER IN VIDEO-ON-DEMAND

A Glow at Yankee Candle

YANKEE CANDLE (YCC) is not the sort of stock that large-cap value player John Maloney usually goes for. But after a closer look, the president of M&R Capital Management saw the light: In recent weeks he bought 200,000 shares of the small-cap growth company, which operates 278 stores mainly at malls in 42 states. It also supplies Bed Bath & Beyond and Linens 'n Things. Yankee has a 36% share of the \$1.6 billion market for premium scented candles. Yankee stock has run up from 14 a year ago to 26 on Sept. 24. Yankee's eye-catching five-year record of rising sales and earnings, plus its strong cash-flow—about \$115 million annually, or \$2.20 a share—make it buyout bait, says Maloney. “We own the shares because of the strong fundamentals,” he insists, “[but] you can’t ignore the takeover appeal.” He thinks it’s worth 33 on fundamentals and 40 in a buyout. The solid cash position has let Yankee buy back shares, notes Maloney. It repurchased \$9.8 million worth of stock, at about 23 a share, in 2003. Same-store sales dropped in the first half of 2003 but should bounce back in the second half, predicts Douglas Lane of Avondale Partners, who rates the stock “outperform.” Yankee expects to open 43 further stores in 2003, and new alliances with other major outlets are possible, says Lane. He expects earnings of \$1.40 a share in 2003 and \$1.68 in 2004, vs. \$1.17 in 2002.



Dendreon: New Weapons Against Tumors

WHAT'S SO HOT about Dendreon (DNDN), which leaped from 3 last year to 9.25 on Sept. 24? The little-known biotech develops immunologically based cancer remedies, and its lead product, Provenge, is aimed at prostate cancer. Mark Monane of investment bank Needham, who rates the stock a strong buy, says Dendreon will soon name a big drugmaker as marketing partner. (Needham has done banking for Dendreon.) Also this year, Dendreon will start Phase 2 trials, which gauge safety and efficacy, for a treatment for breast, colorectal, and ovarian cancer. Monane says Provenge's early trials show a “significant positive survival effect” on prostate patients. He says Food & Drug Administration fast-track status and a “special protocol,”

which lets Phase 3 results (human testing) be the basis for an application, almost assure Provenge's approval by late 2004. It could be on the market in 2005. Monane sees Dendreon in the black in 2006, with earnings of 4¢ a share on sales of \$100 million. Thereafter, sales could hit \$140 million, with earnings of 76¢. George Farmer of Fortis Securities also rates Dendreon a strong buy. He says initial Phase 3 results show Provenge has an “excellent chance” as a treatment for prostate cancer.

A SHARP RALLY



Sweet Licensing Deals For Acacia

ACACIA TECHNOLOGIES GROUP (ACTG) could be beneficiary of the popularity of video-on-demand (VOD)—movies provided for a fee by hotels and on cable TV. So says Paul Sethi of Vertical Ventures Investments, who thinks the shares, which vaulted from 1.18 on Mar. 1 to 5.51 on Sept. 24, could double in a year. Acacia has signed licensing pacts for its patented Digital Media Technology, which enables transmission of VOD. It has inked deals with LodgeNet, the leader in hotel VOD, and CinemaNow, the Internet biggie. It also has deals with several adult Web sites. But the big gains will come from cable-TV giants, such as Time Warner. CEO Paul Ryan says that with Acacia's 22 worldwide patents, he expects media and cable moguls to seek licensing. On-demand movies, according to Forrester Research, will account for 40% of cable-TV viewing by 2006. Sethi says Acacia has cash of \$35.8 million, or \$1.82 a share, but will post a loss in 2003. In 2004, he figures it could earn 25¢ a share on sales of \$35 million. Several hedge-fund managers who declined to be named, continue to buy shares. ■

VAULTING UP ABRUPTLY



BusinessWeek online Gene Marcial's Inside Wall Street is posted businessweek.com/today.htm at 5 p.m. on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor the author hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

From juicy idea to global brand



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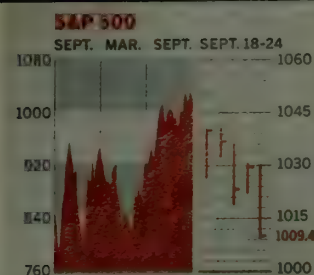
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Figures of the Week

STOCKS

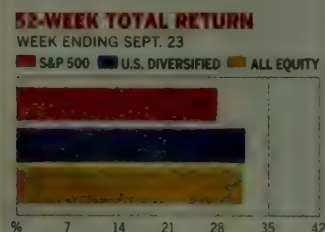
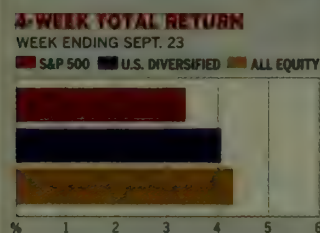


COMMENTARY

Stocks fell sharply on Sept. 24, with the NASDAQ Composite, S&P 500, and Dow down 2.1%, 1.6%, and 1.3%, respectively. The main culprit: OPEC said it would shave production by 3.5% to prop up oil prices. Investors worried that what's good for oil producers could be a hit to the U.S. and the world economy—just as both were beginning to make a comeback.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS



Data: Standard & Poor's

U.S. MARKETS

	SEPT. 24	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1009.4	-1.6	14.7	23.2
Dow Jones Industrials	9425.5	-1.3	13.0	22.7
NASDAQ Composite	1841.7	-2.1	38.1	56.0
S&P MidCap 400	521.1	-0.7	21.2	29.4
S&P SmallCap 600	243.5	-2.0	23.8	32.5
Wilshire 5000	9807.6	-1.4	17.6	26.0

SECTORS

	SEPT. 24	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	582.0	-1.5	7.3	12.7
BW Info Tech 100**	322.4	-1.7	13.0	31.8
S&P/BARRA Growth	515.3	-1.9	14.6	20.7
S&P/BARRA Value	490.8	-1.3	14.7	26.0
S&P Energy	198.3	1.2	8.3	16.4
S&P Financials	344.6	-0.1	16.0	26.2
S&P REIT	107.0	1.1	17.8	14.7
S&P Transportation	180.1	-0.9	6.0	11.2
S&P Utilities	109.3	0.2	11.5	22.6
GSTI Internet	138.8	-1.2	25.9	125.5
PSE Technology	631.4	-3.2	37.8	62.0

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	SEPT. 24	WEEK	% CHG YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	990.1	-1.4	17.2
London (FT-SE 100)	4236.4	-1.3	7.5
Paris (CAC 40)	3263.8	-3.8	6.5
Frankfurt (DAX)	3307.3	-7.1	14.3
Tokyo (NIKKEI 225)	10,502.3	-4.4	22.4
Hong Kong (Hang Seng)	11,295.9	1.4	21.2
Toronto (S&P/TSX Composite)	7602.3	-0.1	14.9
Mexico City (IPC)	7788.1	0.5	27.1

FUNDAMENTALS

	SEPT. 23	WEEK AGO
S&P 500 Dividend Yield	1.52%	1.62%
S&P 500 P/E Ratio (Trailing 12 mos.)	28.9	28.8
S&P 500 P/E Ratio (Next 12 mos.)*	16.7	16.7
First Call Earnings Revision*	0.61%	0.57%

TECHNICAL INDICATORS

	SEPT. 23	WEEK AGO
S&P 500 200-day average	979.1	926.4
Stocks above 200-day average	82.0%	82.0%
Options: Put/call ratio	0.71	0.79
Insiders: Vickers NYSE Sell/buy ratio	5.11	4.99

BEST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Divsfd. Metals & Mining	16.0	306.8
Internet Software	15.1	137.5
IT Consulting	13.0	136.3
Gold Mining	12.3	105.0
Tobacco	12.0	96.4

WORST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Semiconductor Equip.	-10.0	306.8
Movies & Entertainment	-7.5	137.5
Diversified Chemicals	-6.6	136.3
Specfly. Appar. Retailers	-6.1	105.0
Aerospace & Defense	-5.8	96.4

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Precious Metals	13.7	Technology	75.2
Technology	7.5	Communications	56.2
Japan	7.4	Latin America	55.0
Small-cap Growth	7.2	Small-cap Growth	46.9
LAGGARDS		LAGGARDS	
Natural Resources	1.5	Domestic Hybrid	17.9
Pacific/Asia ex-Japan	1.7	Miscellaneous	18.3
Miscellaneous	2.2	Japan	23.1
Domestic Hybrid	2.8	International Hybrid	23.8

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Apex Mid Cap Growth	29.5	PFds. Intnet. Ultsr. Inv.	246.9
U.S. Gl. Wld. Pr. Minls.	19.4	Jacob Internet	213.5
Scudder Gl. & Pr. Mts. S	18.9	Apex Mid Cap Growth	158.9
Thurlo Growth	18.8	RS Internet Age	157.6
LAGGARDS		LAGGARDS	
Rydex Dynam. Vent. 100	-12.0	Rydex Dynam. Vent. 100	-72.5
PFds. UltSh. OTC Inv.	-12.0	PFds. UltSh. OTC Inv.	-72.3
Oppenheimer Real Ast. A	-8.9	Frontier Equity	-63.9
Potomac Sm. Cap/Sh. Inv.	-7.0	Potomac OTC/Short Inv.	-46.2

INTEREST RATES

	SEPT. 24	WEEK AGO
KEY RATES		
Money Market Funds	0.61%	0.61%
90-Day Treasury Bills	0.93	0.94
2-Year Treasury Notes	1.60	1.61
10-Year Treasury Notes	4.14	4.13
30-Year Treasury Bonds	5.09	5.09
30-Year Fixed Mortgage †	5.90	6.38

†BankQ

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	WEEK AGO
General Obligations	3.75%
Taxable Equivalent	5.36
Insured Revenue Bonds	3.86
Taxable Equivalent	5.51

THE WEEK AHEAD

CONSUMER CONFIDENCE

Tuesday, Sept. 30, 10 a.m. EDT » The Conference Board's September confidence index probably inched up to 81.4, from 81.3 in August. That's based on the median forecast of economists surveyed by MMS International.

PURCHASING MANAGERS' INDEX

Wednesday, Oct. 1, 10 a.m. EDT » The Institute for Supply Management's industrial-activity index for September very likely

moved up a tick, to 54.8%, from 54.7% in August.

CONSTRUCTION SPENDING

Wednesday, Oct. 1, 10 a.m. EDT » Building outlays in August are forecast to have climbed 0.4%, following July's 0.2% increase.

FACTORY INVENTORIES

Thursday, Oct. 2, 8:30 a.m. EDT » August manufacturing inventories probably fell 0.2%. In July, inventories were drawn down by another 0.5%. With inventories

falling in 29 of the past 30 months, factory output should pick up as the economy improves.

EMPLOYMENT

Friday, Oct. 3, 8:30 a.m. EDT » Nonfarm payrolls in September are expected to have fallen by 3,000, after a drop of 93,000 in August. Manufacturers probably trimmed 30,000 jobs on top of last month's 44,000 cuts. The small decline in payrolls very likely pushed the unemployment rate up to 6.2%.

The BusinessWeek production index improved to 200.7 for the week ended Sept. 13, up 5.5% from 192.2 a year ago. Before calculation of the week moving average, the index jumped to 203.3.

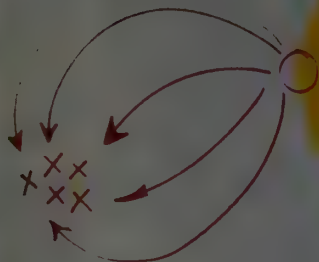
BusinessWeek

For the BW50, more invest data, and the components of the production index visit www.businessweek.com/magazine.

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The Companies

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

A
 Abbott Laboratories (ABT) **72**
 Acadia Technologies (ACTG) **162**
 AlCompany.com **89**
 Amazon.com (AMZN) **115**
 America Online (TWX) **58, 89, 168**
 Amgen (AMGN) **72**
 Amis Holdings **124**
 Anteon (ANT) **147**
 Apple Computer (AAPL) **32**
 Applied Materials (AMAT) **147, 160**
 Avondale Partners **162**

B
 Bank of China **67**
 Bank One (ONE) **44**
 Barnes & Noble (BKS) **100**
 Beacon Hill Asset Management **122**
 Bear Stearns (BSC) **16, 48**
 Bed Bath & Beyond (BBBY) **162**
 Bianco Research **122**
 Biogen (BFEN) **72**
 BMW **62**
 Boeing (BA) **82**
 Boston Consulting Group **100**
 Bridgeway Ultra Small Company Fund (BRSIX) **147**
 BSKyB (BSY) **58**
 Burlington Industries **100**

C
 Caci International (CAI) **147**
 Carrefour **100**
 Charter One Financial **122**
 China Agricultural Bank **67**
 China Construction Bank **67**
 Cincinnati Bengals **96**
 CinemaNow **162**
 Cisco Systems (CSCO) **58**

Citigroup (C) **16, 36, 44**
 CLSA Asia Pacific Markets **67**
 Comcast (CMCSK) **94**
 Commerce Bancorp (CBH) **122**
 ConocoPhillips (COP) **48**
 Countrywide Financial (CFC) **122**
 Credit Suisse First Boston (CSR) **51, 124**

D
 Darden (DRI) **144**
 Dassault Systems **134**
 Dealogic **124**
 Del Monte Foods (DLM) **100**
 Deloitte Research **26, 100**
 Dendreon (DNDN) **162**
 Dial (DL) **100**
 Dow Chemical (DOW) **154**
 Dresdner RCM Global Investors **122**
 DuPont (DD) **154**

E
 Eastman Kodak (EK) **142**
 Edwards Lifesciences (EW) **82**
 EMI Group **94**
 Enron (ENRNQ) **129**
 EOG Resources (EOG) **48**

F
 Fahey O'Connor **20**
 FedEx (FDX) **13**
 Fiat (FIA) **62**
 Fifth Third Bancorp (FITB) **122**
 Firsthand Technology Value Fund (TVFQX) **147**
 Fnac **68**
 Ford (F) **36, 50, 62**
 Forrester Research (FORR) **92**
 Fortis Securities **162**
 Fortress Global Investigations **51**
 FPA New Income Fund (FPNIX) **147**

Friedrich Air Conditioning **89**
 Fujifilm (FUJII) **142**

G
 Gabelli Gold Fund **147**
 Gap (GPS) **112**
 Gehry Technologies **134**
 Genentech (DNA) **72**
 Golden Star Resources (GSS) **152**
 Goldman Sachs (GS) **58, 124**
 Google **89, 168**
 Gracie Media **115**
 Green Hills **100**
 Greenwich Capital **122**
 Gynetics **100**

H
 Harmony Gold Mining (HMY) **152**
 Hewlett-Packard (HPQ) **26, 32, 82, 142**
 Hilton Hotels (HLT) **89**
 Hispanic Broadcasting (HSP) **58**
 Honda (HMC) **50, 62**
 Hops Grillhouse & Brewery **144**
 Hummingbird Value Fund **154**
 Hunt Construction **134**
 Huron Consulting Group **22**
 Hyundai **62**

I
 IAM Gold (IAG) **152**
 IBM (IBM) **32**
 ImClone Systems (IMCL) **51**
 Industrial & Commercial Bank **67**
 IndyMac Bankcorp (NDE) **122**
 Inktomi **89**
 Intel (INTC) **26, 36, 147**

J
 Janus (JANSX) **147**

J.C. Penney (JCP) **112, 154**
 JetBlue Airways (JBLU) **58**
 Johnson & Johnson (JNJ) **26, 72**
 Johnson Associates **16**
 J.P. Morgan Securities (JPM) **41**
 Juniper Networks (JNPR) **147**

K
 Kmart (KMRT) **100**
 Kroger (KR) **100**

L
 Lamps Plus **89**
 Lehman Brothers (LEH) **16, 58**
 Leica **142**
 Leo Burnett USA **112**
 Lexus **50**
 Linens 'n Things (LIN) **162**
 Lipper **147**
 LodgeNet (LNET) **162**
 LookSmart (LOOK) **89**
 Lycos (TRLY) **89, 168**

M
 Macy's (FD) **112**
 M&R Capital Management **162**
 Marriott International (MAR) **89**
 Matthews Japan Fund **147**
 Meetup.com **61**
 Mercedes-Benz (DCX) **62**
 Merrill Lynch (MER) **52, 129**
 Metropolitan West Asset Management **147**
 Microsoft (MSFT) **32, 36, 89, 94, 168**
 Minolta **142**
 Morgan Stanley (MWD) **36, 40, 58, 72, 94, 122, 124**
 Motorola (MOT) **52**
 MTB Investment Advisors **52**

N
 National Football League **96**
 Nations Funds **147**
 NBC (GE) **16**
 Needham **162**
 Newmont Mining (NEM) **152**
 News Corp. (NWS) **58**

Nintendo (NTDOY) **58**
 Nissan (NSANY) **62**
 North Fork Bancorp (NFB) **122**
 NPTel **160**
 Nucor (NUE) **26**

O
 Olympus **142**
 Oracle (ORCL) **147**

P
 Panasonic **54, 142**
 Percutaneous Valve Technologies **82**
 Placer Dome (PDG) **152**
 Potash Corp. of Saskatchewan (POT) **48**
 PricewaterhouseCoopers **16, 51**
 Procter & Gamble (PG) **14, 26**
 Progressive **134**
 Provident Bankshares **122**
 PSA Peugeot Citroën (PEUGY) **62**
 PurchasePro **58**

R
 Renault **62**
 Retail Forward **100**
 Revlon (REV) **100**
 R.J. Reynolds (RJR) **56**
 Roche Group (RHHVF) **72**
 Roland Berger **62**
 Roslyn Bancorp (RSLN) **122**
 Rydex Juno (RJUX) **147**

S
 Schlumberger (SLB) **160**
 Scudder Gold & Precious Metals Fund (SCGD) **147**
 Seagate Technology (STX) **124**
 Sears (S) **154**
 Sharman Networks **64**
 Smith & Wollensky's (SWRG) **158**
 Sotheby's Holdings (BID) **51**
 Sprint (FON) **52**
 Standard & Poor's (MHP) **48, 67, 122, 147**
 Sun Microsystems (SUNW) **26, 52, 147**

T
 Target (TGT) **100**

TCW Group **122**
 TIAA-CREF **44**
 Time Warner (TW) **94**
 TiVo **94**
 Tocqueville Gold (TGLDX) **147, 152**
 Toshiba **142**
 Town and Country Restaurant **56**
 Toyota (TM) **50, 62**
 T. Rowe Price (TR) **147**
 Tularik (TLRK) **72**
 Tyco International

U
 UBS (UBS) **100, 112**
 Univision Communication **58**
 U.S. Bancorp Pipe (USB) **89**

V
 Verizon (VZ) **58, 112**
 Vertical Ventures ViroLogic (VLGC) **58**
 Vivendi Universal **62**
 Volkswagen **62**

W
 Walgreen (WAG) **112**
 Wal-Mart Stores **100, 168**
 Walt Disney (DIS) **112**
 Warner Books (T) **94**
 Warner/Chappell **112**
 Washington Mutual **122**
 White Oak Growth Fund **147**
 William Blair International Growth Fund (WE) **100**
 Winn-Dixie Store **100**
 WorldCom **51**
 WR Hambrecht **112**

X
 Xerox (XRX) **26**
 Xoma (XOMA) **72**

Y
 Yahoo! (YHOO) **89**
 Yankee Candle

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The High Cost of Low Prices

SHOPPERS LOVE Wal-Mart Stores Inc. Its policy of “everyday low prices” saves consumers billions of dollars every year, helping to keep the nation’s inflation rate low. But its methods of squeezing out those low prices—paying salaries below the poverty line, building superstores that crush local mom-and-pop shops, and pushing manufacturers to the wall for savings are generating a strong backlash. So, too, is the exportation of the Bentonville (Ark.) behemoth’s Southern-style cultural conservatism into big-city and suburban regions of America that hold different social values. There’s a growing sense that Wal-Mart may be too powerful. If the company is to continue to succeed, it may have to focus more energy on dealing with these concerns.

By almost any measure, Wal-Mart is the best global benchmark for corporate efficiency. It is a master of information technology. It is a champion of global supply-chain management. It is also the nation’s largest private employer and one of its biggest taxpayers (page 100).

But for those sales clerks trying to raise families, working for Wal-Mart often means hard times. The average salary in 2001 actually put them below the federal poverty line. This could soon mean hard times for the company as well. Wal-Mart estimates that 44% of its 1.4 million employees will leave in 2003, and it needs to hire 572,000 workers just to stay even. This may prove difficult, given its pay scale, once the recovery takes hold and the job market tightens up.

A full-time sales job at Wal-Mart pays below the poverty line

Wal-Mart’s active participation in America’s culture wars has also sparked concern. Citing “customer preferences,” the giant retailer doesn’t carry CDs or DVDs that bear a parental-warning sticker, and it obscures the covers of certain magazines. But Wal-Mart doesn’t survey customers to get their opinions, and its censorship is often capricious. Maxim gets yanked, but Rolling

Stone, with a nearly naked Britney Spears on the cover, doesn’t. Hunting rifles may be sold, but X-rated songs may not. These choices, of course, reflect the values of Wal-Mart’s Southern origins, and they are perfectly legitimate. But they are not the values of all of America, particularly those urban regions outside the South that Wal-Mart wants to enter. The company’s cultural gatekeeping offends many people who see it as insulting and threatening to their choice of available entertainment.

Wal-Mart also terrifies many U.S. manufacturers. The giant chain is by far the largest purchaser in America. Coffee-

makers, toasters, toothbrushes, TVs—virtually anything that goes into a house must now be designed to meet specifications set by Wal-Mart. If American producers can’t meet these specs, Chinese companies will. Last year Wal-Mart imported \$12 billion worth of Chinese goods accounting for 10% of total U.S. imports from China. That good for American customers? You bet. And for U.S. suppliers? Many are hurting.

As an increasingly national powerhouse, Wal-Mart finds that it makes sense to move beyond its current practices. Raising workers’ salaries above the poverty level, perhaps through profit-sharing, will help the company attract a stable workforce in higher-income parts of the U.S. as in Europe and Japan. And accepting different cultural values of communities outside the chain’s regional base would ease social and political resentment of the giant retailer. In Europe, Wal-Mart decided not to censor magazines, sports, and movies. And the chain has agreed not to sell guns in Los Angeles, the site of its first inner-city supercenter. This increased sensitivity to local values is a good start toward what could be Wal-Mart’s evolution into an even more successful global corporation.

No Excuse for Rigging Searches

Search engines are blossoming in a terrific business: a powerful tool for finding out just about anything. But a *BusinessWeek* investigation reveals that some search engines are rigged: They accept payment from companies for special treatment, which frequently boosts their ranking in search results. And they do it without telling Web surfers that they’re receiving what is, in effect, paid advertising. Deceiving customers is never a wise business decision.

Which companies are doing it? Not Google, the leading search engine, which relies on its own technology for Internet search and clearly marks the paid ads it carries. Also uses Google’s search technology. But Yahoo!, MSN, and Lycos do accept paid inclusions (page 89). The *BusinessWeek* investigation showed that 10 out of 20 advertisers and marketers interviewed saw their rankings move up in searches on these sites after they paid to have their listings considered. This kind of hidden advertising will undermine the search business as consumers come to realize that they are not getting objective information but predominantly listings of deep-pocketed companies. And if companies can secretly pay to be elevated toward the top of seemingly objective search results, the Internet’s ballyhooed role as a democratic medium will certainly erode.

Google and AOL are setting a high standard. Yahoo! and Microsoft are not. C’mon, guys. Shape up.

October 13

TIME (P.104)

RIGHT TO
BLAME CHINA? (P.32)

3 9042 05800613 8
SONY IN GAMES (P.50)

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BusinessWeek

2003

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THE WEB MOGUL

RORY DILLER

er had a secret
n to take over
endi. But he does
e a not-so-secret
n to rule the Web.

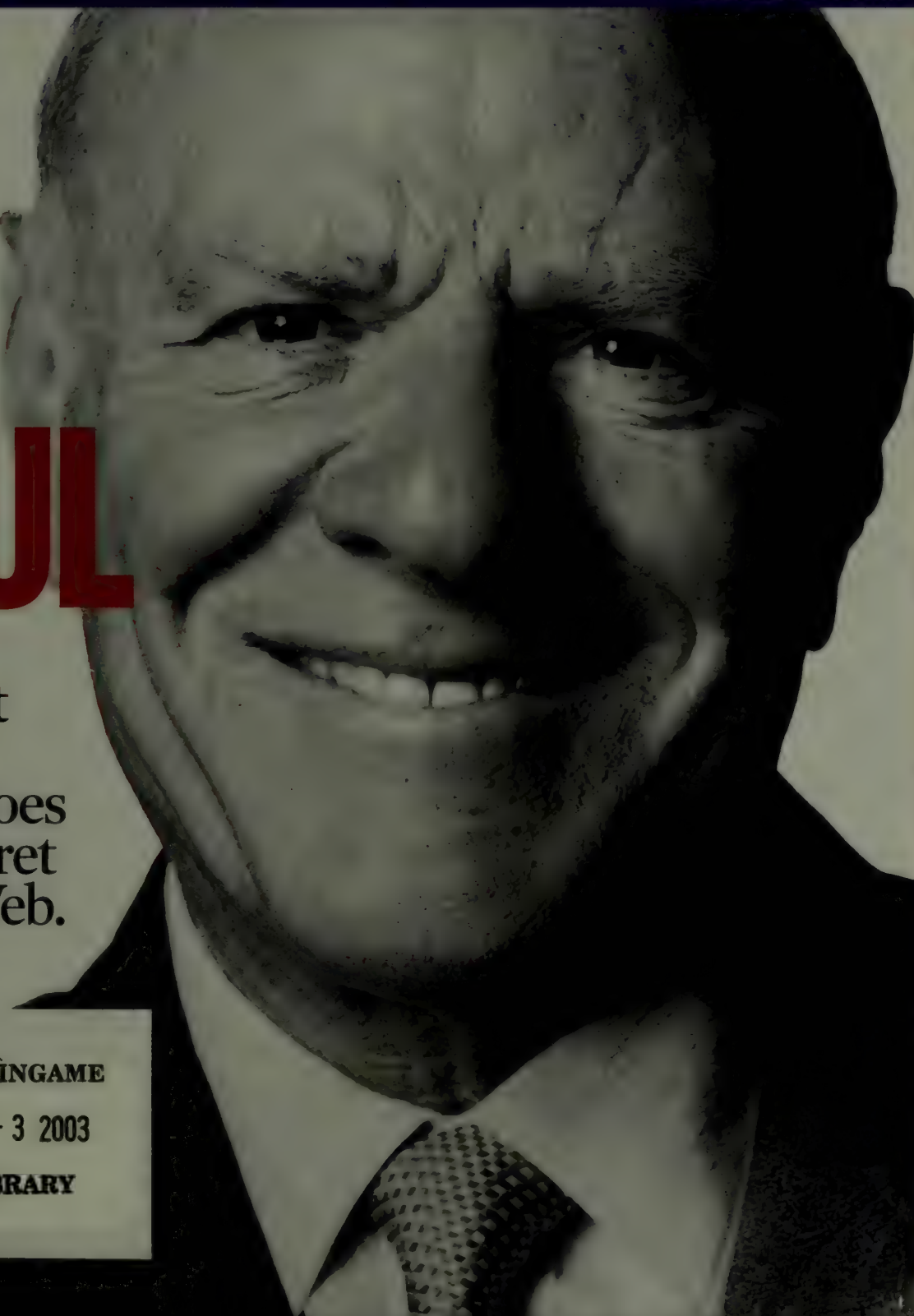
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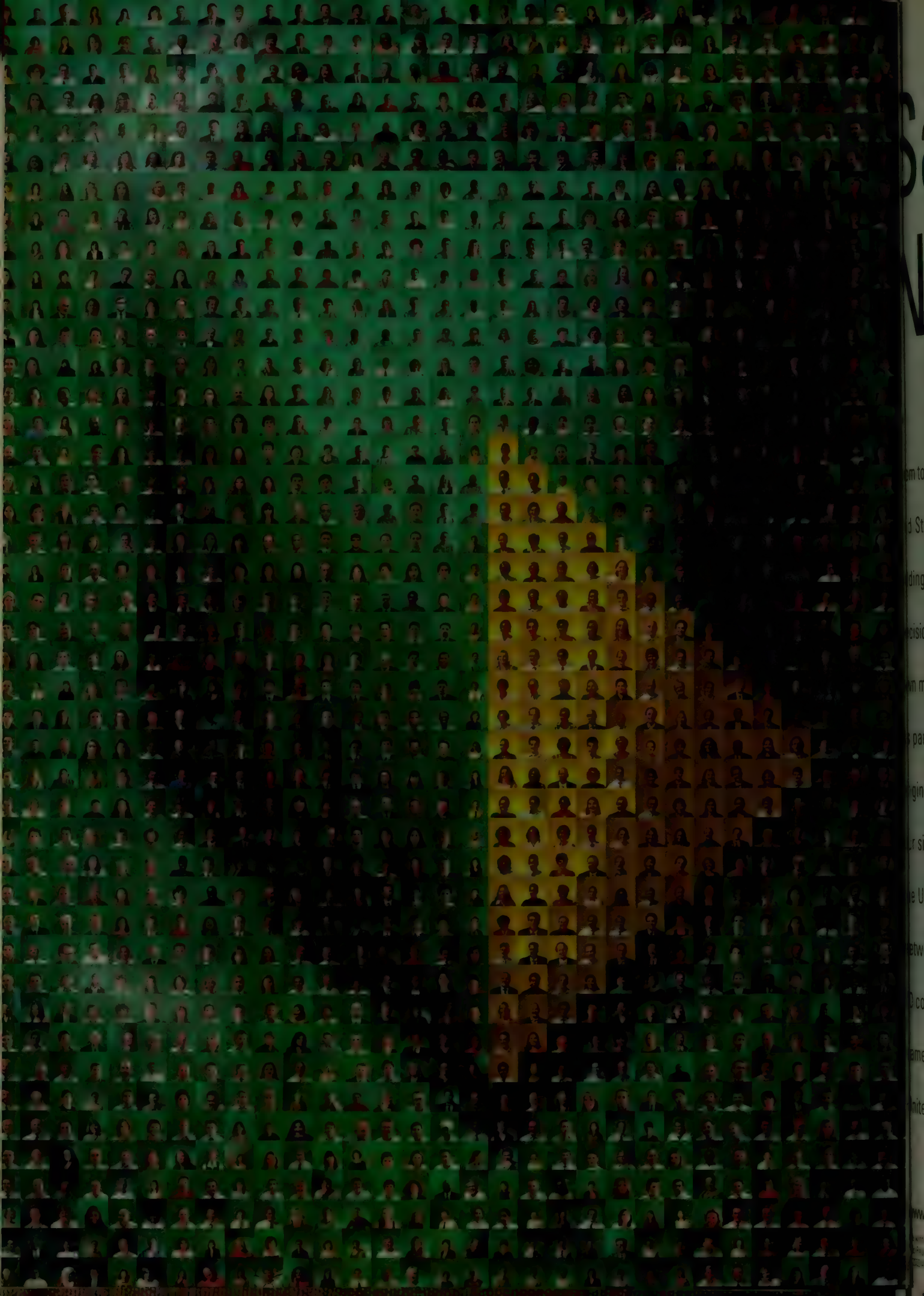
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And this is just the beginning. Because at GM, we're dedicated to building safe cars and trucks. And making sure you feel protected every time you get behind the wheel.

NIGHT VISION. ALLOW US TO SHED SOME LIGHT.

A lot of companies are using cameras these days. But only GM is using one like this: a high-powered, ferroelectric heat-sensing camera – aka, Night Vision. Offered exclusively in the Cadillac DeVille, this first-of-its-kind feature harvests



thermal-imaging technology from the military to help drivers see beyond the range of low beam headlights. By projecting infrared images onto the windshield, Night Vision can give drivers some extra time to react.

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The National Highway Traffic Safety Administration (NHTSA) gave Chevy Impala five stars for frontal crash safety, the highest government rating.**



Beneath the inviting exterior of the Saturn Ion is a mighty steel spaceframe. This reinforced safety structure helps preserve occupant space in a crash.



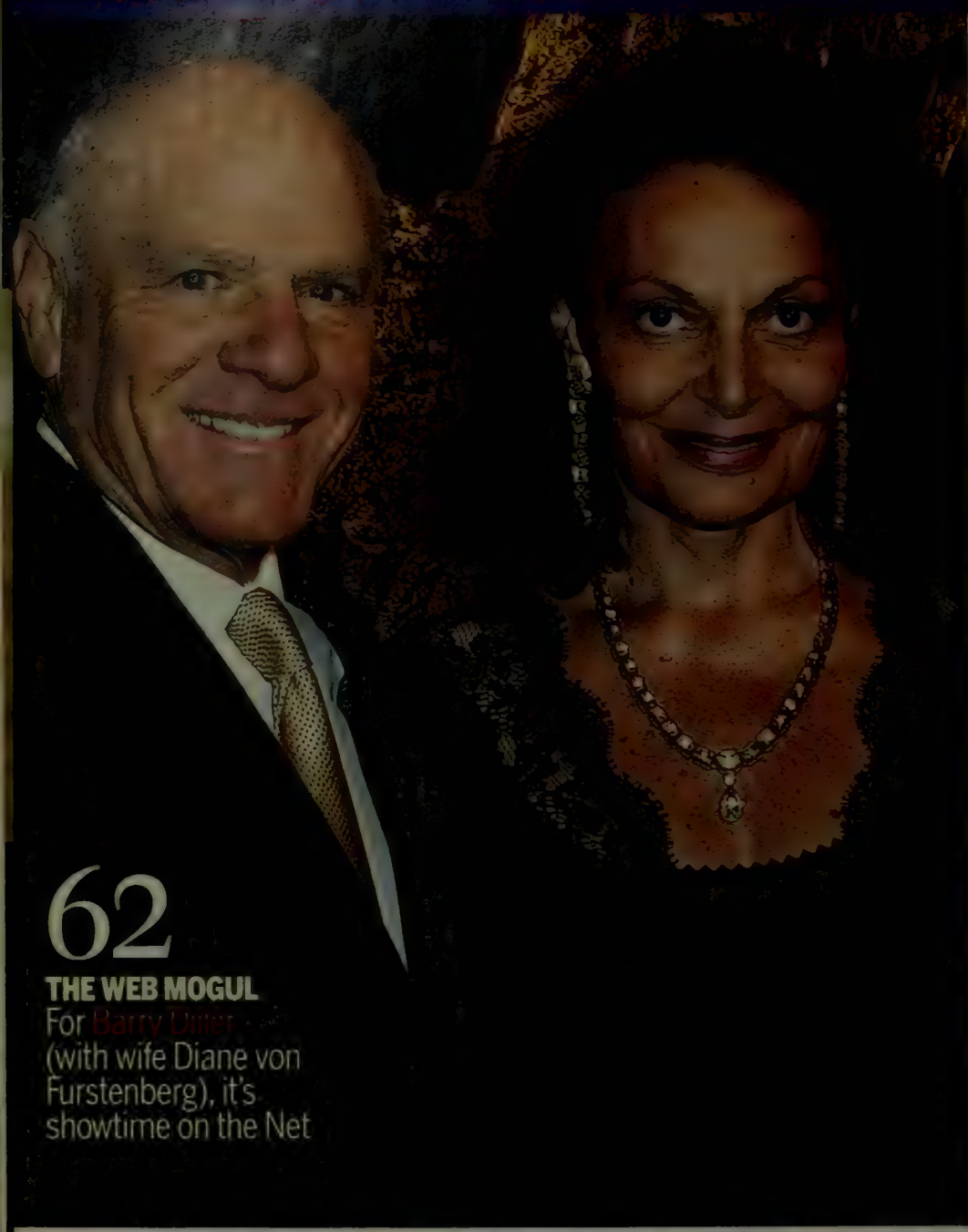
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62

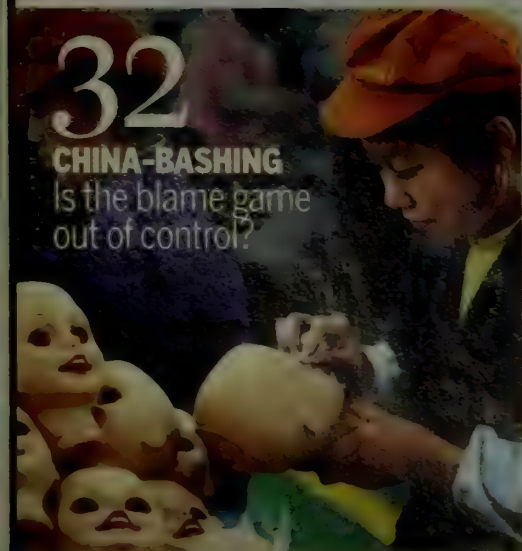
THE WEB MOGUL

For **Barry Diller** (with wife Diane von Furstenberg), it's showtime on the Net

32

CHINA-BASHING

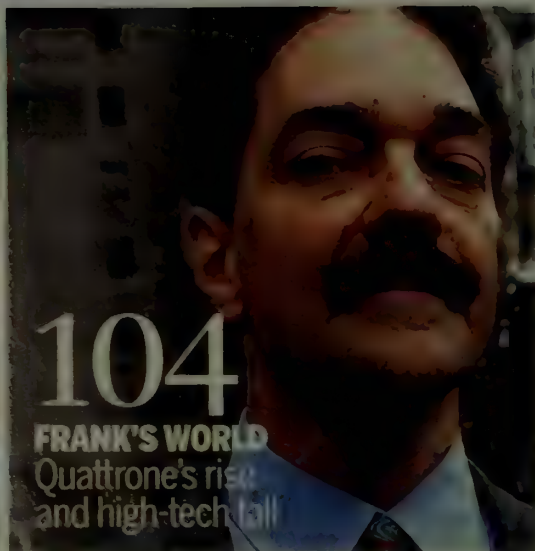
Is the blame game out of control?



104

FRANK'S WORLD

Quattrone's rise and high-tech fall



Cover Story

62 The Web Mogul

Barry Diller never had a secret plan to take over Vivendi Universal. But he does have a **not-so-secret plan** to rule the Web with a raft of businesses in everything from travel to mortgages to dating

70 Commentary: Barry Diller

Three ways he can overcome investor doubts about InterActiveCorp

News: Analysis & Commentary

32 The Job Drain: Is It China's Fault?

The major reasons for America's manufacturing losses lie elsewhere

36 Commentary: Iraq

Getting serious about shrinking the

37 Clark: Marching Down the Middle

The general's economic agenda will borrow from the Clinton playbook

38 Commentary: Drug Prices

Why all countries should pay a fair s

42 The Cacophony in Online Music

A slew of legal sites is warming up

44 Unhappy Customers at WaMu

Is the mortgage lender growing too f

46 In Business This Week

International Business

50 Finland: Nokia

The giant phonemaker makes the leap into the game business

55 Commentary: Britain

Healthy rivalry in the Labour Party

56 India: High-Tech King

Azim Premji expands his empire

58 Asia: Shipbuilding

Korea and Japan launch giant freight

60 International Outlook

France's economic reforms may fizzle

Economic Analysis

Economic Viewpoint

er: Regulate the Big Board

Economic Trends

ns' health; CEO turnover and
prices; chief financial optimists

Business Outlook

Housing is coming back to earth
n: Higher interest rates ahead

Government

Washington Outlook

he President is in such a slump

Special Report

Good Timing for Small Business

ttle guys are in the right place—the
e sector—at the right time

Helping Hand from the States

programs for health-care coverage

Small Company, Big Back Office

ased software is hiking efficiency

Science & Technology

Japan's Power Play

ountry's electronics giants are
oping ever-smaller fuel cells

Developments to Watch

Corporation

E: Jeff Immelt's New Push

ms to build customer loyalty—and
—by going beyond the call of duty

The BW50 Revisited

year update shows that customer
ce above all kept the winners on top

Legal Affairs

Inside Quattrone's Money Machine

the meteoric career of Silicon Valley
ce kingpin Frank Quattrone
ed with such lightning speed

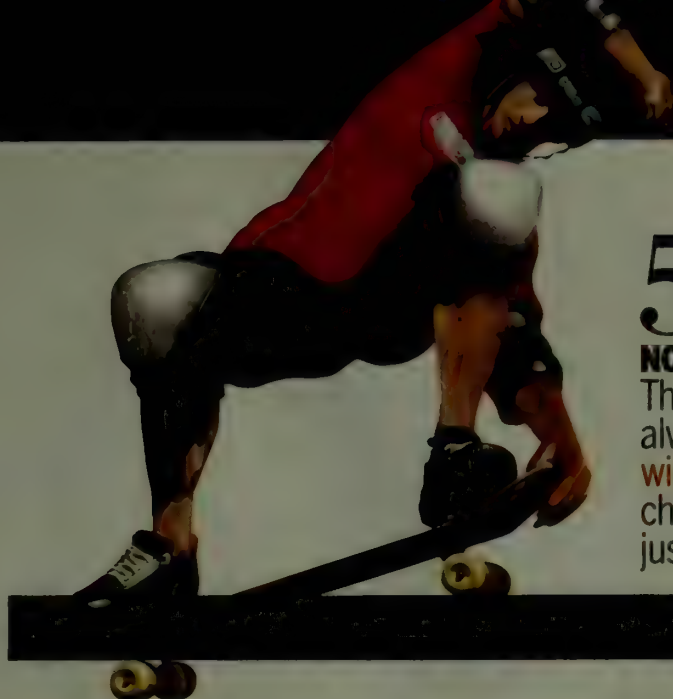
Finance

New Clout for Shareholders

ocracy will change the boardroom

Commentary: Fannie and Freddie

the agencies ought to split up



50

NOKIA'S BIG LEAP

The Finnish giant has
always excelled at
wireless. Now it's
chasing **gamers**, not
just road warriors

117 TIAA-CREF Gets a Makeover

It's becoming more market-driven

120 Commentary: FASB

It's drowning in details—once again

Information Technology

24 Wildstrom: Technology & You

The wireless walkie-talkie market

122 How Can Sun Fix Itself?

After a huge quarterly loss, McNealy has
to sharpen its customer focus

Social Issues

125 The Split over School Vouchers

Why some black Democrats in D.C. are
siding with the GOP on a pilot program

Management

126 He Bet on Botox—and Won

David Pyott transformed Allergan.
Where is he taking its blockbuster drug?

Personal Business

130 Write-offs: The Fine Print

They've become all too common. Here's
how to assess their hit to the bottom line

132 Q&A: Shuhei Abe

Why he thinks Japan looks good again

134 The Fine Art of Finding the Fat

Trans-fats won't be listed on all labels till
2006. Here's how to spot them now

136 Atlantic City's Touch of Class

The brand-new Borgata hopes to bring
back high rollers

138 Air Travelers: Save Now or Later

Discount carriers cost less, but it's tough
to earn a frequent-flier freebie

140 Platform Tennis, Anyone?

You can play this outdoor hybrid of
tennis and squash all winter long

142 Footnotes

Locating the nearest flu shot; the
downside of expensing options;
disposable DVDs; laboring for a Big Mac

144 The Barker Portfolio

The Grasso Affair will someday blow
over. When that happens, expect the Big
Board to go public

146 Marcial: Inside Wall Street

Features

13 UpFront

18 Readers Report

20 Corrections & Clarifications

22 Books: Shulman:

The Betrayal of Work

Appelbaum, Bernhardt, Murnane:

Low-Wage America

Scotti: *Sudden Sea*

Tapscott and Ticoll:

The Naked Corporation

148 Figures of the Week

150 Index to Companies

152 Editorials

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Systems ②

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Systems ③

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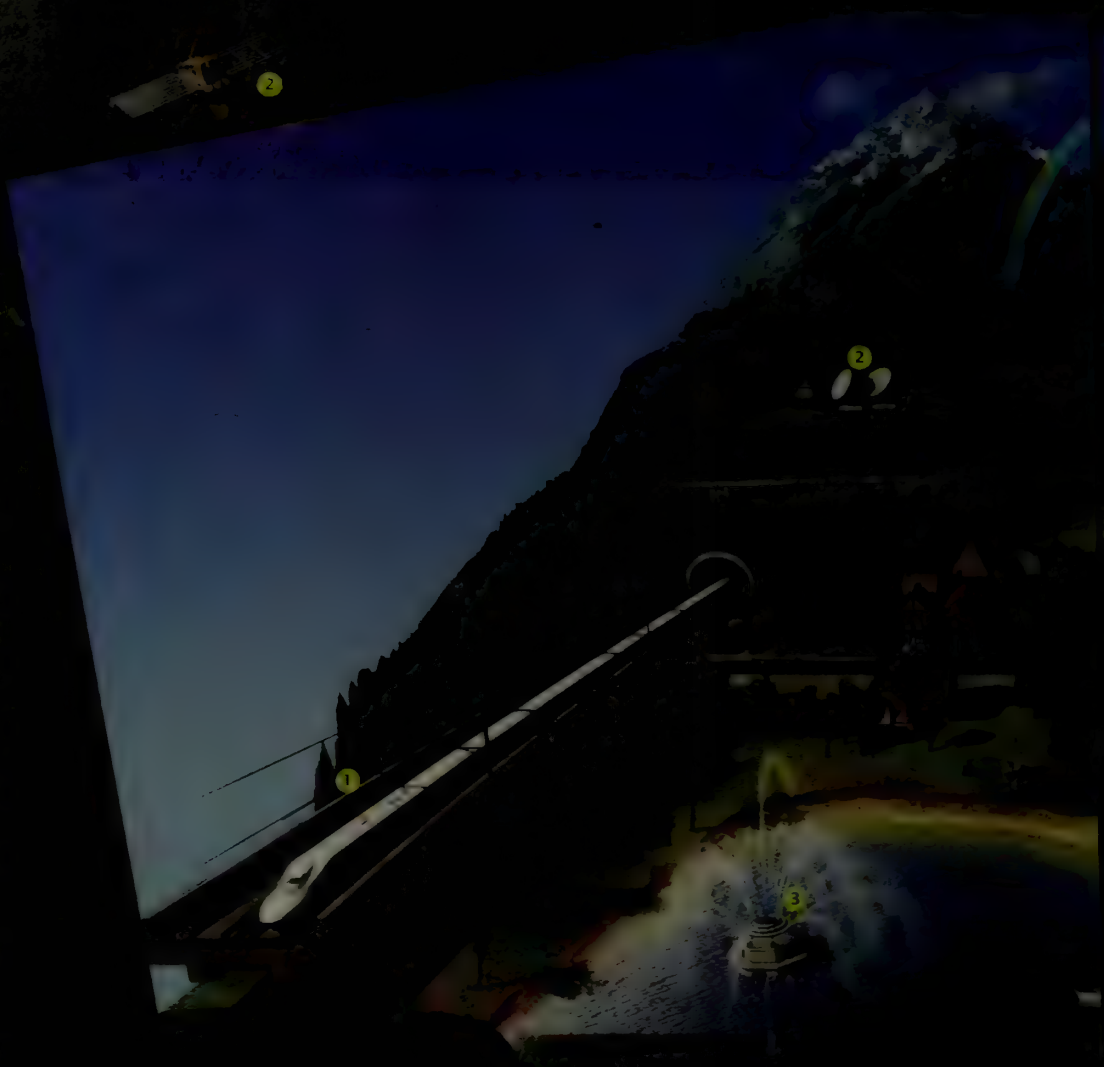
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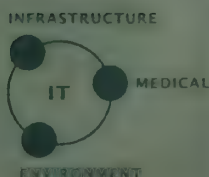
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IN ACTION



- 12 Intelligent Transport Systems
- 13 Open MRIs
- 14 Cancer Diagnosis and Therapy
- 15 Electron Microscopes
- 16 Railway Traffic Management Systems
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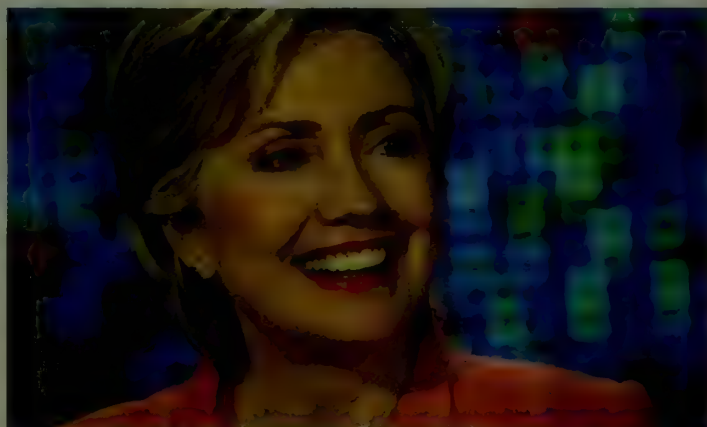
The High Cost of Small Cons

Small-business owners are often reluctant to spend time and money on due diligence when hiring employees or making deals. This, says former prosecutor Robert Silbering, is why they are some of the easiest marks for con men and embezzlers



Microsoft Cuts The Chatter

While its decision to limit MSN's popular Internet chat rooms to paying customers has critics crying foul, it makes sense both legally and economically



Why Hillary Should Run

Hillary Rodham Clinton has repeatedly denied she will take a run at unseating George W. Bush in November, 2004. However, if the Democratic Party's only true star genuinely wants to be President, her time is now. By 2008, it may well be too late

Thalidomide's Surprising Act IV

Once hailed as a miracle cure, the drug became notorious for causing thousands of birth defects. Then it proved to be a relief for patients suffering from a rare immune disorder. Now, it shows promise as a cancer fighter, and its noxious side effects can be largely eliminated

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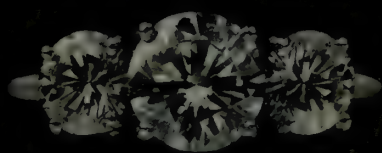
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and white tees.

The Concord Saratoga Chronograph.



JP Front

"There are a lot of things we have to do, and that's one of them."

—Mark Fabiani, adviser to Wesley Clark, on having Clark officially register as a Democrat (page 49)

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GOOD COUPLES WISHES ON STAR

OCT. 2. Hewlett-Packard launched a \$300 million global marketing campaign to tell consumers on its latest

of the Mouse House's family appeal.

The first joint marketing project will plug a new thrill ride at Epcot Center, called Mission: Space. The flight simulator is a collaboration between Disney designers and HP's NASA-hardened engineers. On Oct. 9, the pair will air TV ads touting the attraction. HP also is planning its first consumer promotion: a sweepstakes offering chances to spend New Year's Eve traveling to Mars (on the ride) and enjoying an HP home-technology makeover.

Will all this liven up what many perceive as HP's reliable, but staid image? "HP's brand is about to go from a walk to a run," says Steven Addis, CEO of Addis Group, a brand-strategy firm. Maybe "Mickey Mouse marketing" is a compliment? —Gerry Khermouch and Ben Elgin



ital imaging and computer products. the bucks don't go there. *BusinessWeek* has learned that HP will invest up to \$100 million more in a 10-year marketing alliance with Disney to give HP some

BLASTOFF
LaserJets to retro rockets



BAD BREAKS

Now, This Is Going to Hurt...

THE LIST OF WOES at HealthSouth keeps growing. The bankrupt hospital chain already faces a criminal investigation into its accounting. Now regulators say that by 2007, at least 75% of patients in a rehab hospital will need to have one of 10 medical conditions for the hospital to get paid by Medicare.

That means **HealthSouth** would lose reimbursements for 39,000 patients, or about 32% of its rehab clients. Before it went into bankruptcy, HealthSouth predicted its 2003 revenue would hit \$4.1 billion, and rehab accounts for most of that. "HealthSouth would have the greatest exposure," says Jeffries analyst Frank Morgan.

HealthSouth could feel the pinch as early as next year. As an interim step, the feds propose that 65% of rehab patients must be receiving treatment for one of 12 conditions by 2004. The government wants patients to recover in nursing homes or at home, where Medicare won't pay. HealthSouth has reserved \$46 million to cover short-term losses from the changes. The company says the government may reconsider, since seniors, a powerful lobbying group, need the hospitals. HealthSouth has a lot riding on it. —Charles Haddad

THE BIG PICTURE

DRUG MONEY The percentage of adults who believe each of the following medications are "very" or "fairly good" value for the money:

OVER-THE-COUNTER DRUGS

OVER-THE-COUNTER DRUGS

VITAMINS AND MINERAL SUPPLEMENTS

BRAND-NAME PRESCRIPTION DRUGS

Survey of 2,098 U.S. adults, Aug. 8-11
Harris Interactive



HIGH TECH

WHAT WAS DICK TRACY'S MONTHLY FEE?

WHEN THE LIGHTS went out on the East Coast this summer, Rick Rashid, Microsoft's head of research, knew about it within minutes simply by glancing at news headlines on his watch. These days, Rashid straps a prototype of the software



giant's latest creation, the Spot watch, to his wrist every morning.

Rashid's timepiece is hardly a fashion statement—a hulking chunk of plastic with an oversized display.

But when the hoi polloi get their hands on Spot watches late this fall, they'll be able to choose from more fashionable models from Fossil and Finnish sports watch maker Suunto. The timepieces will sell for \$100 to \$300. Buyers will have to pony up \$9.95 a month or \$59 a year for the service, which beams the latest news, weather, and a host of other data using FM airwaves.

Microsoft isn't the first to make a run at wearable technology. Five years ago, Sun Microsystems unveiled the Java ring, a concept that one day might let users go to any Web-connected device and call up their personal information. Today, the Java ring is little more than a memory. Rashid hopes his watch won't meet a similar fate. "We'll cross our fingers," he says. And he'll hope that consumers will want to be connected as much as he does. —Jay Greene



OVER THERE

MULTISCREEN MOSCOW When Paul Heth came to Moscow in 1993, the cinemas were dumpy and single-screen. No popcorn, no comfy seats. Ten years later, the plush multiplex has arrived. KinoStar De Lux—11 screens, 3,250 seats—opened on Sept. 19, thanks to Heth and Nation Amusements. They want to build others in Moscow and St. Petersburg. More will follow: Prof-Media News & Publishing is building a new chain, and Karo Film is updating some of its 15 theaters and adding more. Only 8% of Russians catch at least one flick a year. But Prof-Media says box-office sales have risen tenfold since 1999. Popcorn, anyone? —Jason Bush

THE LIST

President Bush's \$20.3 billion proposal to rebuild Iraq includes far more than just roads and bridges:

\$35 MILLION

for on-the-job training for private businesses

\$30 MILLION

for half-day English classes for 5,000 workers

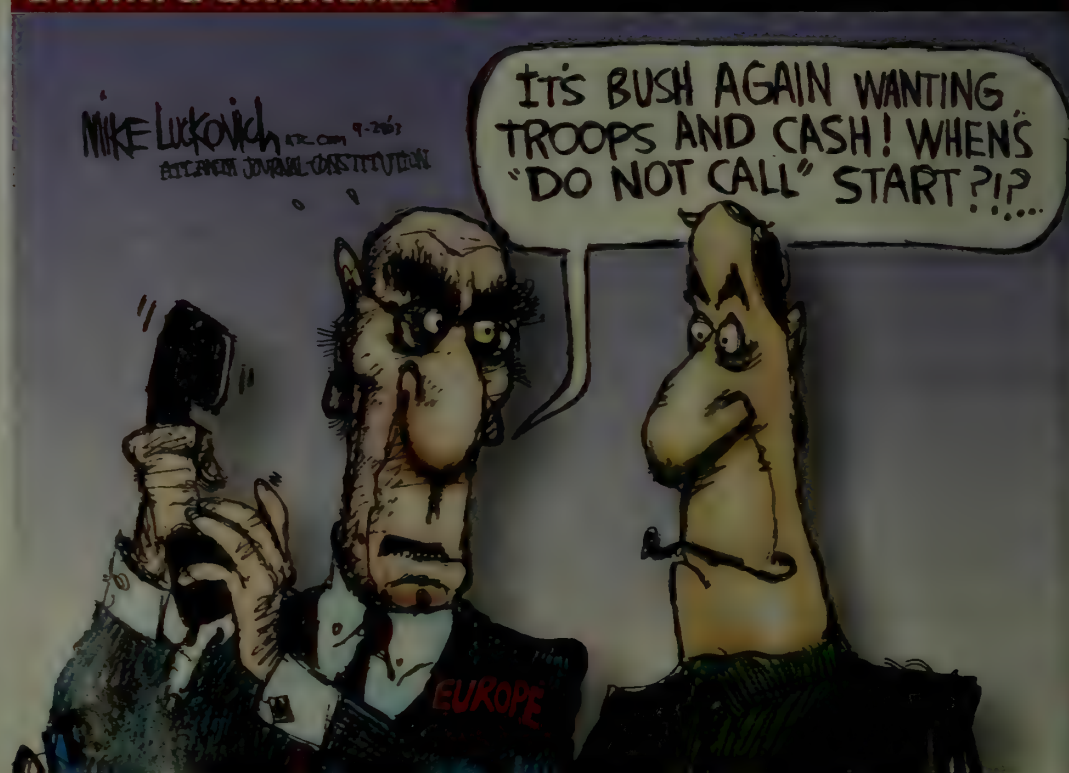
\$9 MILLION

to update the postal system and establish Zip codes

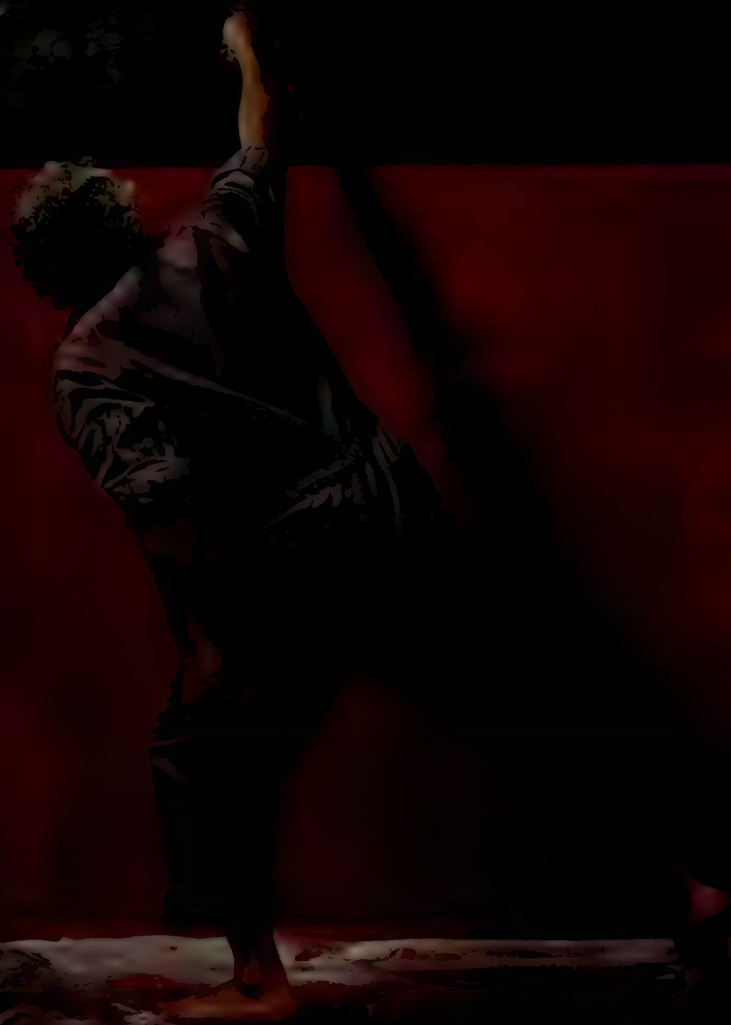
\$2 MILLION

for 40 garbage trucks

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FACE TIME

RAGHURAM RAJAN



FROM BHOPAL TO THE IMF

In *Saving Capitalism from the Capitalists*, University of Chicago finance professor **Raghuram Rajan** argues that free financial markets can benefit the poor. Now he's getting a chance to test that theory. On Oct. 1, the 40-year-old academic became the International Monetary Fund's new chief economist.

He's also the first top IMF economist from a developing country. His predecessor, **Kenneth Rogoff**, calls that "a huge plus." Born in Bhopal, India, Rajan could boost the IMF's credibility with those who say its lending policies favor creditors and are too restrictive for developing nations. "You don't want to impinge on the sovereignty of [developing countries]," says Rajan, "but... you want to give the people a better chance."

Unlike his predecessors, Rajan studied banking, not economics. With many economic meltdowns accompanied by banking crises, Rajan may be uniquely equipped to address them. —*Brian Hindo*

TRIBES & TAXES

HOW CASINOS ARE HOGGING THE CHIPS

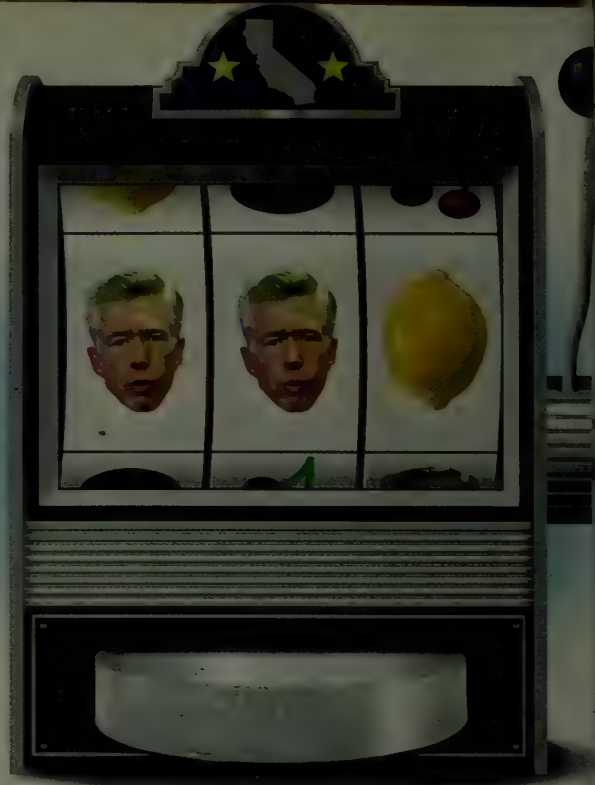
THE CALIFORNIA recall election is shining a spotlight on how little Native American casinos pay in taxes. Candidate **Arnold Schwarzenegger** has risen in the polls since running ads that urge tribes to "pay their fair share" of state taxes. But under deals negotiated by Governor **Gray Davis** in 1999, California's Native American casinos don't contribute directly to state coffers. Instead, they pay about 3% of their winnings to other tribes and to reimburse state and local governments for some costs.

Critics say Davis should have cut a better deal. **C. Shawn Bookin**, a casino analyst at money manager Trust Company of the West, figures the pact has cost the state \$700 million in tax revenue yearly, which could have supported

a \$12 billion bond issue.

Nationally, 6 of the 24 states with Native American gaming get a piece of the action. Connecticut collects 25% of slot machine revenues from its two tribal casinos, worth some \$400 million a year. Other states seem to be moving in that direction. Arizona and Wisconsin recently renegotiated pacts to obtain substantial tax payments.

Last March, Davis suggested raising \$1.5 billion in taxes from the casinos to help solve the state's budget crisis. But he cut that figure in half after tribes began running TV ads that praised the contributions of gaming to the state. They've since contributed big bucks to help recall rivals. Here's something everyone will agree on: There's a huge jackpot at stake. —*Christopher Pali*



TELECOM TALES

A CALL IS A CALL IS A CALL

BY YEAREND, 150,000 Americans will use the Web to make phone calls. By 2005, that's expected to swell to 1 million, says researcher IDC. But as consumers discover the joy in Web phones, so too are state regulators—and that could crimp profits in the fledgling field.

Regulators took notice last year when **Vonage**, an Edison (N.J.) Web-calling service, advertised that it could replace traditional phone

service. On Aug. 13, Minnesota became the first state to declare Vonage a telephone service subject to state regs, including paying fees to fund 911 service. Such fees could hike providers' costs 10%, says CIBC World Markets.

On Sept. 24, Vonage appealed, saying it shouldn't be regulated because it's an "information" service. A day earlier, Vonage asked the FCC to protect the industry against state regulators. The FCC says it will examine the issue by yearend. Alabama, Colorado, Illinois, Ohio, Pennsylvania, and Wisconsin are mulling similar rules. So much for cheap rates on Web phones. —*Catherine Yang*



THE STAT

20

Percentage of Gen Xers who expect help from their parents to pay for a child's college education. But only 7% of those parents are stashing cash to put a grandchild through college.

Data: UCLA School of Law

December 31, 2008

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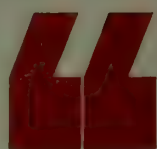
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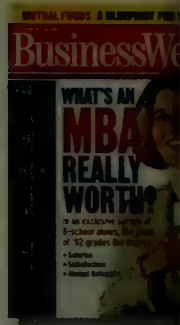
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My own experience of the MBA program was that it was worthwhile but... I'm still waiting for the six-figure salary.

—George A. Reynolds
 Annamoe, Ireland



ALL MBAS ARE NOT CREATED EQUAL

"WHAT'S AN MBA really worth?" (Cover Story, Sept. 22) produced some very interesting results. But if my MBA taught me anything, it was not to draw incorrect inferences from statistical data. There are two main problems with your survey: 1) Self-reporting surveys are usually biased—the respondents who did well will be more likely to reply than those who did not. 2) The survey results for each category (men, women) must be compared with results for other graduates who did not do an MBA. For example, if 10% of MBAs earn over \$200,000 and 10% of all non-MBA graduates earn likewise, then one can conclude that there is no connection between high salaries and MBA degrees.

In addition, two other factors need to be considered: The use of "averages" in a sampling population where a few individuals will have very high salaries while many will have much lower salaries. Try averaging the salaries of Microsoft Corp. workers with and without William H. Gates III's salary! And does an MBA lead to high achievement or do naturally high achievers tend to do MBA degrees?

My own experience of the MBA pro-

gram was that it was worthwhile but negative NPV (net present value) program. I'm still waiting for the six-figure salary.
 —George A. Reynolds
 Annamoe, Ireland

Editor's note: Median salary data is available at businessweek.com/bschools.

WHO NEEDS IT? All a manager needs to know is: where to outsource production (China), and where to outsource call centers, accounting, and most everything else (India).

—Lloyd Eskildsen
 Scottsdale, Ariz.

A SURVEY OF ALUMNI from less than 10% of the accredited MBA programs shows less than 5% of all programs giving a degree in the U.S.—and one that focuses solely on the top 30 programs—scarcely claim to discern what an MBA is worth. The sample is not representative of the typical MBA. More relevant would be comparisons with similarly talented and situated people without the degree. When such analyses have been conducted, in an investment bank and in consulting firms, there is typically no difference in career outcomes between those v-

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Readers Report

CORRECTIONS & CLARIFICATIONS

In "Striking out on their own" (Cover Story, Sept. 22), Northwestern University Kellogg School of Business alumnus Lloyd Cheu's quote should have referred to a \$350 million bond deal he once structured, not a \$350 billion deal.

Our Q&A, "Colin Powell: On Iraq, Bush, and his job" (News: Analysis & Commentary, Sept. 22), should have said "... Baltic states added to NATO," according to the State Dept. transcript, not Balkan states.

In "Sweet licensing deals for Acacia" (Inside Wall Street, Oct. 6), Paul Sethi's estimates should have read: "By the end of 2004, he figures Acacia could post quarterly earnings of 25¢ a share on run-rate sales of \$35 million," instead of: "In 2004, he figures it could earn 25¢ a share on sales of \$35 million."

"Enron's bankers feel the heat" (In Business This Week, Sept. 29) should have noted that the three Merrill Lynch employees indicted by the Justice Dept. no longer are with the company.

and without the MBA degree. I applaud your efforts to at least ask the question of the consequences of getting an MBA.

—Jeffrey Pfeffer
Stanford University
Graduate School of Business
Palo Alto, Calif.

YOU TERM THE charitable giving of your MBA Class of '92 "impressive." But the numbers you report tell a dramatically different story. Some 25% of your respondents gave nothing at all. Among the other 75%, the average contribution was slightly more than \$7,300 over two years. That's \$3,650 per year—and your MBA survey respondents had an annual compensation last year of \$387,600. Thus your tightwad givers donated less than 1% of their annual income to charity, and overall the Class of '92 averaged far less.

—David J. Cohen
Washington

MORE MEDIA CROSS-OWNERSHIP WILL HELP, NOT HURT, LOCAL NEWS

"HOW MICHAEL POWELL could have the last laugh" (Media, Sept. 22) misperceives the value of cross-ownership for newspaper and broadcast companies. Cross-ownership allows the delivery of better local news more quickly to communities,

large and small. Such strong local news is expensive to produce, however, and the Federal Communications Commission's 28-year ban on common ownership has meant curtailment of local news, particularly in smaller markets where the economics of television ownership are the most difficult. Cross-ownership is a top-line strategy, not a cost-cutting tactic. Consumers know the difference, and they know how to change channels and newspaper subscriptions.

—J. Stewart Bryan III
Chairman and Chief Executive
Media General Inc.
Richmond, Va.

THE WAR IN IRAQ: SMART MOVE—OR DECEIT?

LET'S BE CAREFUL before associating the term "massive intelligence failure" with Iraq policy ("Iraq: Hard lessons and how to use them," News: Analysis & Commentary, Sept. 22). When intelligence debunks the notion of Iraq's buying enriched uranium from Niger while the Administration embraces it as fact, this is not a failure of intelligence. It's merely a lie. When intelligence discounts any meaningful Iraq-al Qaeda link that nonetheless becomes a centerpiece of Administration speechmaking, this, too, is not a failure of intelligence but yet another lie. When the Defense Secretary establishes a task force in the Pentagon to mine intelligence data in order to support a decision that has already been made, this is not a failure of intelligence. It's a subversion of the policymaking process.

An independent investigation by Congress into what data the intelligence community provided policymakers and how they used it would help immeasurably in understanding what went wrong.

—Colonel Harvey R. Greenberg (Ret.)
U.S. Air Force
Westford, Mass.

REMOVING IRAQ as a focal point was wise, foreclosing having to face a much better prepared Iraq later.

—Matt Ryan
Bremerton, Wash.

NUSSBAUM WRITES THAT "the level of anti-Americanism around the world has never been higher." I suggest that this applies strictly to the present Bush Administration. Except for the usual incorrigible groups, the great majority of the world looks at America with awe and pride and some (flattering) envy.

—Walter Kuitert
Meaford, Ont.

SMARTER RESEARCH MEANS HIGHER PRODUCTIVITY

"REINVENTING CORPORATE R&D" (Science & Technology, Sept. 22) provides perspective on how U.S. industrial search remains productive even though the rate of growth of in-house research and development has slowed or even declined in some areas. The old NIH (invented here) attitude has faded, though it's never entirely gone, and managers are judged on their use of technical advances wherever they may be originated. There has been a vast increase in joint technical programs since the early 1980s, even between divisions of the same companies, and there has been an obvious rise in corporate partnering, often leading to mergers or acquisitions. Corporate R&D has been reinvented. Added productivity brings more responsibilities and, of course, greater strategic value for the corporate growth plan.

—Herbert I. Fu
Stamford, Conn.

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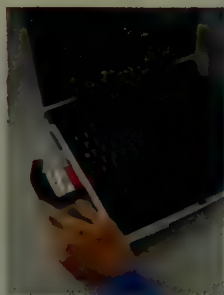
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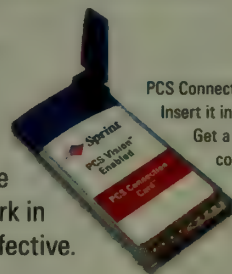


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Stuck in the Slow Lane

THE BETRAYAL OF WORK: How Low-Wage Jobs Fail 30 Million Americans

By Beth Shulman; New Press; 255pp; \$25.95

LOW-WAGE AMERICA: How Employers Are Reshaping Opportunity in the Workplace

Edited by Eileen Appelbaum, Annette Bernhardt, Richard J. Murnane; Russell Sage Foundation; 535 pp; \$45

American workers have had quite a roller-coaster ride in the past decade as an era of plentiful jobs and fat paychecks gave way to stubborn unemployment and skimpy raises. One thing that didn't change, though, was the mass of very low-wage jobs that are often the only thing open to millions of workers who

lack the skills or education needed to get on a career track.

Barbara Ehrenreich's best-seller, *Nickel & Dimed*, gave a first-person tour of what it's like to be a cashier or bed-changer with slim prospects of making it into the middle class. Now, two more-scholarly books give the numbers behind the anecdotes, showing how subpoverty jobs have become a permanent and growing blight on the U.S. economy. *The Betrayal of Work*, by former union official Beth Shulman, offers a polemical but accessible portrait of America's 30 million-plus underclass. *Low-Wage America*, a vast undertaking by 38 economists, sociologists, and other academics, is a surprisingly readable description of what's driving the expansion of dead-end jobs across the economy.

Shulman, a former vice-president of the United Food & Commercial Workers union, which represents supermarket and clerical employees, has gathered an impressive array of studies and statistics on the army of working poor. The security guards, home-health aides, child-care workers, maids, tellers, cooks, and hairdressers she describes earn less than the federal poverty level (currently about \$9 an hour for a family of four). While minorities are overrepresented in this group, two-thirds are white. Some 60% are women, and the vast majority are adults—only 7% are teens. Most lack a college degree. Shulman shows how low-wage workers, in addition to their lousy pay, are more likely than the rest of us to have rigid or late-night work schedules, unsafe working conditions, and inadequate or nonexistent health care.

More troubling are the forces that trap many of these workers in a career cul-de-sac. These are the focus of *Low-Wage America*, which offers 12 in-depth studies of different industries, from hotels to steelmaking. With funding from the Russell Sage and Rockefeller Foundations, its authors interviewed a total of 1,700 managers and workers at 464 employers and queried 10,000 more via an extensive survey.

The authors show how technology, deregulation, and globalization have prompted employers to compete with another by slashing labor costs. Neither *Low-Wage America* nor *The Betrayal of Work* really explains why these familial trends have cut so much more sharply against less-skilled workers than against college-educated ones. But since experts have been debating this conundrum for more than a decade with no real conclusion, perhaps both books are right to sit back and deal directly with the what.

Low-Wage America's most compelling idea: Many low-skilled jobs don't need to pay poverty wages at all. The authors demonstrate this with numerous real-life examples.

For instance, an examination of smaller machine and electrical-parts manufacturers in central New York State finds that several pay unskilled new hires \$8 to \$9 an hour. Most of their rivals in the area, however, offer just \$6 to \$7. It turns out that the high-road outfits use a different strategy to cope with competition from low-wage countries. They invest in scads of training, use worker-

involvement schemes to keep productivity high, and motivate employees with profit-sharing and pay-for-performance bonuses. Although the companies all "face broadly similar market pressure, we find clear and compelling evidence that managers do have discretion in their employment practices and wage policies," the authors say.

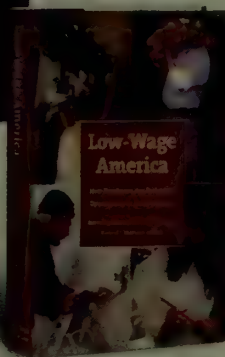
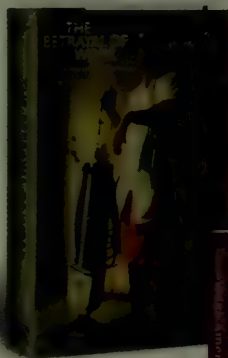
One of the book's most surprising findings is that employers who use alternative approaches to compete in low-skilled industries often rely on new labor

market institutions. In industries as diverse as hospitals, hotels, and hosiery, companies band together to train workers, set industry standards, and help each other learn how to make strategies such as teamwork really work. Often, local government bodies lend crucial support, with see money for training and coordination with community

colleges. There's a clear role, the book argues, for government to support management choices that help less-skilled workers.

Still, such examples have been scarce in the U.S. in recent years. Unless more employers decide that being competitive doesn't necessarily mean cutting pay as low as it can go, the ranks of low-wage workers will continue to grow.

—By Aaron Bernstein



Employers can compete without paying such low wages

Brief

Now and Tell

NAKED CORPORATION

How the Age of Transparency Will Revolutionize Business

Don Tapscott and David Ticoll; Free Press; 304 pp; \$28

Over the past decade, the forces driving corporate openness have been gaining ground. Greater public access to information, aided by new

communications technologies, is

beginning to change companies' relationships with employees, partners, shareholders, and customers. To many executives, the prospect of ever greater candor is terrifying. But not to worry, say authors Don

Tapscott and David Ticoll: For those who embrace it, transparency can be a source of competitive advantage.

In *The Naked Corporation: How the Age of Transparency Will Revolutionize Business*, Tapscott and Ticoll suggest that stakeholders' demands for

information give companies a new way to differentiate themselves—as honest, responsive, and sensitive to specific needs, such as the environment or work conditions. This is a fresh and compelling thesis, backed up by some persuasive evidence. But the authors tend to exaggerate just how much things have changed. Moreover, their book is riddled by jargon and phrases that seem eerily ill-timed, such as “the new business integrity.”

Tapscott and Ticoll, whose previous book was *Digital Capital*, provide numerous examples of the rewards candor can bring. At insurer Progressive Corp., callers asking for price quotes are given several—one from Progressive and others from rivals. The authors report that they sometimes take Progressive deal even when the price is higher. Outdoor clothing retailer Patagonia Inc. prospered after explaining why it was forsaking cheap cotton grown with pesticides for the organic variety.

However, Tapscott and Ticoll turn a blind eye to some recent developments that contradict their thesis. These include the opposition within Silicon Valley to expensing stock options, a move aimed at increasing clarity about

these perks' impact on earnings. And the authors downplay such basics as the fact that openness in pricing would prevent a supplier from negotiating different deals with different customers.

Properly deployed, candor can give companies a leg up. But if the past three years of restatements and accounting scandals have taught us anything, it's that secrecy has its own seductive charms. No one should expect the tight-lipped titans of Corporate America to bare all anytime soon.

—By Louis Lavelle

Swept Away

SUDDEN SEA

The Great Hurricane of 1938

By R.A. Scotti; Little, Brown; 279pp; \$24.95

By the time Hurricane Isabel stormed ashore on Sept. 18, it had been downgraded to a Category 2 'cane. Even so, its fury left some 6 million people without power and claimed more than 30 lives. How much worse would the toll have been had Isabel retained her original Category 5 rating? *Sudden Sea: The Great Hurricane of 1938* by R.A. Scotti, which looks at the worst natural disaster in 300 years of New England history, provides a disturbing point of reference. In a few hours at the very end of summer, this extreme storm—with gusts of 186 mph—killed nearly 700 and wiped away entire beach communities on Long Island and Rhode Island.



Scotti is a novelist (and sister of *BusinessWeek* Senior Editor Ciro Scotti) who has heard survivors' stories since her youth in Rhode Island. And she has penned a fast-paced book built around a few of the most vivid tales.

For example, there's the heartbreaking account of Joseph Mateos, who watched helplessly from the fields of his farm as the school bus carrying four of his children was marooned on the causeway leading across a nearby cove. No sooner had the driver ushered the children off the bus than they were swallowed up in the storm surge.

A splendid history, *Sudden Sea* might also be a harbinger, given meteorologists' warnings that we may face more violent Atlantic 'canes in coming years. At the very least, it might cause you to reconsider getting that beach house. ■

—By William C. Symonds

Middleware. It's on Broadway.



BY STEPHEN H. WILDSTROM

Push-to-Talk: Nextel Is Still the One to Beat

Nextel Communications is finally getting some respect. The wireless-phone carrier is known for its oddball technology, clunky handsets, and a heavily blue-collar customer base. But mostly it's known for its push-to-talk feature that allows its phones to be used as walkie-talkies. Suddenly, however, everyone wants a piece of the walkie-talkie action.

Verizon Wireless is the first competitor to take advantage of technological and regulatory changes that allow other carriers to imitate the Nextel service. In testing both, I found that Verizon's offering is nowhere near as good as Nextel's. But AT&T Wireless and Sprint PCS are readying their own versions, and my guess is that within a couple of years, good push-to-talk capability will be standard on many wireless phones.

Direct Connect, as Nextel calls its service, is easy to use. To begin a connection, you select a Direct Connect in the phone's contact list and press a button to send an alert. (You also can connect with several people at once, but these groups must be set up for you by Nextel.) You then press and hold a button on the side of the phone to talk. When you release the button, others in the conversation hear a beep indicating that it is O.K. for someone else to talk.

A DIRECT CONNECT CONVERSATION produces a different experience from a regular call. The push-to-talk feature tends to discourage people from rambling. And because you have the floor for as long as you hold down the talk button, there are no interruptions. Direct Connect has made Nextel popular among construction workers, delivery drivers, and others who are used to working with two-way radios. Until recently, push-to-talk worked only within a local service area, but Nextel recently made it available nationwide in a bid to broaden its appeal beyond the blue-collar market. National plans with unlimited Direct Connect start at \$60 a month.

Unlike many wireless carriers, Nextel is profitable, with the highest revenue per customer in the business, and it is likely to keep its push-to-talk edge for a while. Other carriers have to emulate the two-way radio service built into Nextel's unique iDEN technology and, as is usually the case, emulation doesn't work as well as the real thing. Verizon's push-to-talk superficially works like Nextel's. But it takes 10 to 15 seconds



after you push the button to establish a connection, something Nextel phones do almost instantaneously. More annoying, there's a delay of at least five seconds after you speak before the person on the other end hears what you've said. The result is a painful pause each time one person finishes speaking.

Verizon is selling push-to-talk primarily as a service for business types. For the time being, at least, it is matching Nextel with a \$60-a-month plan, including unlimited push-to-talk. The only phone currently available is a Motorola V60p, a slightly smaller but less capable imitation of Motorola's Nextel handsets. Unlike nearly all phones in its \$150 price class, it lacks a color display. Oddly, although

push-to-talk uses Verizon's advanced data capabilities, the V60p handset offers no data services, such as e-mail—while Nextel's does. Verizon will offer more capable phones in coming months.

A company called fastmobil offers a sort of do-it-yourself push-to-talk service on GSM networks (including AT&T, Cingular, T-Mobile, and most carriers outside of North America). Its \$3.95-a-month

**For now,
Verizon's
version is
nowhere
near as good
as Nextel's**

"fastchat" service works on some Nokia and Sony Ericsson phones, including the popular Nokia 3650. Although it inconveniently uses one of the standard phone buttons instead of a special push-to-talk button on the side, the service works much like Verizon's.

I doubt Verizon's offering will be a big hit in its present form. But it, and other carriers, will approach Nextel's service over time—and a technology once derided as the essence of blue-collar communications is becoming hip. ■

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THE NEW RINGY DINGY



BY ROBERT KUTTNER

The Big Board: Crying Out for Regulation

The New York Stock Exchange, disgraced by the latest scandal, is desperately trying to salvage its regulatory authority. Its much-anticipated report on its own corporate governance has been deferred, pending deeper reforms. This whole sorry affair, like the Enron/Arthur Andersen mess and the Wall Street stock-analyst scandal, cries out for government regulation.

I once debated a conservative who had mostly contempt for regulation. Was there any agency he liked? "The SEC," he finally replied. Why? Because financial markets offer so many opportunities for insiders to gain at the expense of investors, he admitted, that ordinary forms of market discipline are not adequate. Amen.

But as recent scandals have revealed, the Securities & Exchange Commission has mistakenly delegated too many regulatory duties to industry bodies. The accountants' professional association and lobbying group, the American Institute of Certified Public Accountants (AICPA), was given de facto control of accounting standards. The National Association of Securities Dealers was allowed to be both self-regulator and self-serving lobby. The stock exchanges were given authority for establishing and enforcing their own rules.

As it turned out, these self-regulatory organizations (SROs) were competent to police small-time larceny but not the systematic conflicts of interest that enrich Wall Street's biggest players. Former New York Stock Exchange Chairman Richard A. Grasso's enormous, unwarranted compensation shows that the collapse of self-regulation is complete. It's time for the SEC to resume direct authority over stock exchanges.

THE IMPLSION OF WALL STREET'S self-regulation was the result of other forms of deregulation. In the 1960s and '70s, there were few big scandals because most conflicts of interest were precluded by government rules. There could be no Enron scandal before the 1990s, since electricity was closely regulated. There was no savings and loan meltdown before the 1980s: S&Ls were tightly regulated. Lucrative self-dealing was less possible because the law wisely segregated commercial banks, investment banks, and insurers into separate industries.

These structural regulatory barriers also reinforced norms of professionalism. Bankers viewed their role as conscientious scrutinizers of corporate loans, not as seekers of what amounted to kickbacks. Accountants saw themselves as agents of rectitude, not of dubious bookkeeping schemes.

But with deregulation came so many opportunities for profiteering through conflicts of interest that self-regulation didn't stand a chance. Stock analysts, now part of investment banking, received CEO-approved money for promoting stocks

of favored corporations. The AICPA didn't resist accounting manipulation because its own blue-chip members were engineering it. The NYSE couldn't heal itself.

After the Enron and WorldCom scandals, Congress passed the Sarbanes-Oxley bill to put accounting under an agency overseen by the SEC. Sarbanes-Oxley addressed board responsibility for financial reports but not other issues of governance. That fell to the stock exchanges and ultimately the SEC.

Now the NYSE has been disgraced not just as a weak regulator but also as another bundle of conflicts of interest. Grasso's grotesque compensation is no anomaly, but a telling reflection that the NYSE is an insider club operated by and for

broker-dealers, specialist traders, investment bankers, and its own executives—at the public's expense.

The NYSE, after all, is a private entity owned by its members. It is no accident that the recent scandal were remedied by outsiders such as New York State Attorney General Eliot Spitzer and Senator Paul Sarbanes (D-Md.) rather than the NYSE, or that pressure for deeper reform is coming from state treasurers, large pension funds, and the SEC, not from Wall Street.

The Grasso pay debacle means the SEC should supervise the NYSE

There is talk of more resignations at the NYSE, more disclosure, tougher standards for corporate boards, and of splitting the Big Board into a stock exchange and an independent regulatory arm. But the clubbiness that produced the Grasso debacle is entrenched in the history and culture of the institution. Even a reformed NYSE should not be writing rules for how corporations should be governed, how exchanges should be run, and how to limit specialist enrichment at investor expense. These urgent questions about the best way to govern a capitalism prone to conflicts of interest should be addressed by Congress and enforced directly by the SEC. ■

Robert Kuttner is co-editor of The American Prospect and author of Everything for Sale.

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BY GENE KORETZ

RUSSIA'S HUGE HEALTH HURDLE

As its economy booms, life spans are still falling

FUELED BY HIGH oil prices, Russia's economy has surged at a hefty 6%-plus rate since 1998, producing big income gains for some groups of workers. A key question, however, is whether the boom is substantially improving the lives of the general population.

The answer suggested by Russia's health indicators—especially life expectancy, which many experts consider the best yardstick of well-being—is disappointing. New data from America's National Center for Health Statistics indicate that life expectancy in Russia was highly responsive to shifts in GDP through most of the 1990s but appears less so in the wake of the recent boom.

Russia's health woes aren't new, of course. Life expectancy edged downward in the decades prior to the breakup of the Soviet Union. Then, in the economic chaos from 1990 to 1994, as per-capita GDP fell by 40%, male life expectancy plunged by more than five years, to 57.6 years, and female expectancy fell three more years, to 71.2 years. More than 60% of these declines were erased after the economy turned around in mid-decade, but the longevity recovery was interrupted by the 1998 ruble crash.

It's no surprise that life expectancy fell in 1999 in the wake of a 4.5% decline in GDP per capita in 1998. Yet while per-capita GDP jumped at a 6% average rate in the following three years, life expectancy continued to slip, falling by half a year for males in 2001, the latest year for which data are available.

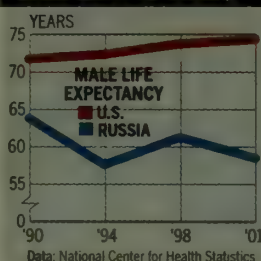
Why hasn't Russia's boom had more impact on its basic health trends? One

reason appears to be that most of the economic benefits thus far have been concentrated in the Moscow area—a situation that is strikingly confirmed by health statistics. Although Moscow's mortality rates were close to nationwide rates from 1990 to 1995, by 2000 they were 20% below rural mortality and 16% below overall urban mortality.

Another factor is the continuing deterioration of the health system. Russian medical officials estimate that some 40% of deaths contributing to its high mortality rate would be preventable with a proper health-care system. But the government still spends only 3.8% or so of gross domestic product on health—less than half the average of developed nations.

The moral suggested by Russia's dire health statistics is clear: Unless it succeeds in spreading the benefits of its surging economy to all its people and starts repairing its medical system, its health problems will inevitably undermine future economic progress.

THE BELL TOLLS EARLIER FOR BORIS



AS THE CEO TURNS

When the boss departs, stocks become riskier

RECENT YEARS HAVE seen a big increase in the turnover rate of corporate top brass and a sharp rise in stock market volatility. The results of a new study by Matthew J. Clayton of Rutgers University, Jay C. Hartzell of the University of Texas, and Joshua V. Rosenberg of the Federal Reserve Bank of New York suggest that the two trends may not be entirely coincidental.

Analyzing 872 CEO turnovers from 1979 to 1995, and controlling for overall stock market price swings, the authors found that a stock's volatility tends to rise after any turnover. But the increase is especially large—as much as 24% for a year or two—after a forced departure. The jumps in volatility presumably reflect investors' uncertainty about a new CEO's ability and business strategy.

This pattern suggests that a corporate board planning to replace a CEO should expect possible negative effects on its

ability to float new stock or participate in a merger. And investors with big holdings in a company whose CEO has been fired might be well-advised to diversify their portfolios.

CHIEF FINANCIAL OFFICERS ARE OPTIMISTS

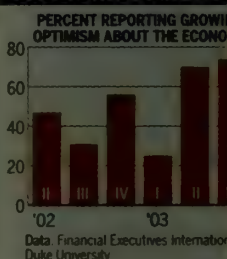
They're bullish about growth and jobs

IT'S TOO SOON to cheer, but the word from the number crunchers in the executive suite is that things are looking up. Chief financial officers of U.S. companies who answered a recent survey expressed more optimism about the economy than they've shown in more than a year. That's according to Financial Executives International at Duke University's Fuqua School of Business, which released the quarterly CFO Outlook Survey on Sept. 30.

Seventy-four percent of the CFOs surveyed said they were more upbeat about the U.S. economy than they were the previous quarter, while just 8% said they were more pessimistic. Their median forecast for growth of gross domestic product over the coming year was 3%. The CFOs also expect capital spending to increase 9% in the coming year. That's up sharply from their forecast of 1.5% in the last quarterly survey. The survey suggests that employment may finally be about to pick up steam as well. No less than 42% percent of the chief financial officers say their firms plan to increase employment over the next year—significantly more than the 26% that expect to cut jobs.

The financial executives surveyed are members of Financial Executives International, a professional organization for CFOs, treasurers, and controllers. The group and Fuqua have conducted the survey since 1996.

CFOs SEE BLUE SKIES AHEAD





AS CFO, YOU HAVE TWO CHOICES:

1. FIND A WAY TO REDUCE HEALTH INSURANCE COSTS.
2. ACQUIRE A TASTE FOR MACARONI-AND-CHEESE DINNERS.

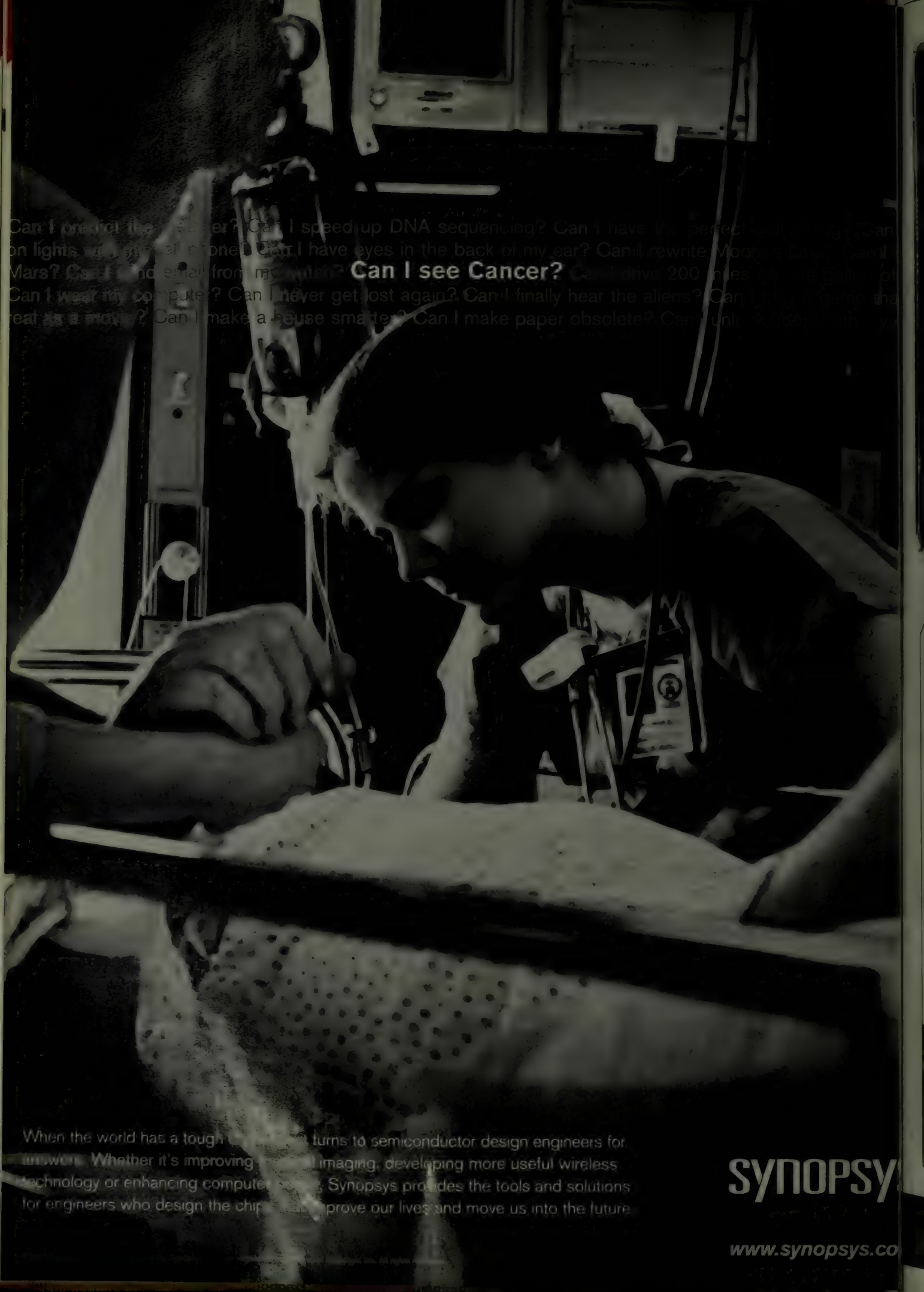
Unless your idea of a power lunch is a heaping helping of orangey-yellow goodness, it's probably a good time to talk to your HR director about Blue Cross of California's new, cost-effective health-coverage solutions. With our new generation of innovative, consumer-directed plans, you can help put a lid on your company's rising healthcare costs. While helping your company weather through tough times, you'll also be giving your employees the power to take control of their own health-coverage costs. So, ask your HR director to show you our affordable, new options—over lunch, perhaps.

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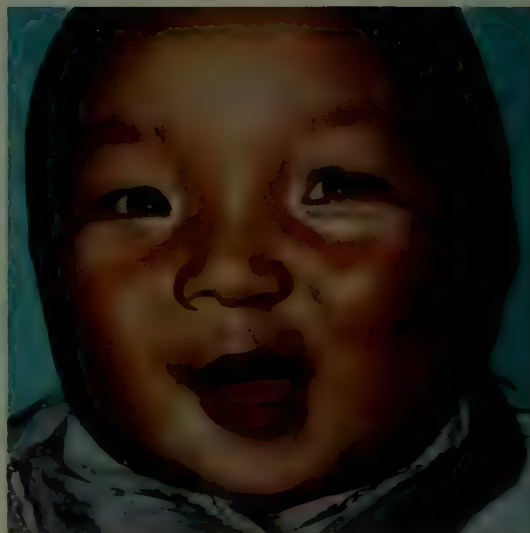
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JAMES C. COOPER & KATHLEEN MADIGAN

Housing: Still Solid, but Creaking a Little

As first-time homebuyers look at steeper prices and mortgage rates

U.S. ECONOMY

"A man's home is his castle" is an adage dying to be updated. Today, a home is also an investment fund, an ATM, and a tax deduction. For the economy as a whole, housing has been a catalyst for this recovery. Indeed, the sector continued to gain ground even while the rest of the economy slogged through a recession. And the

latest data suggest home sales will set a new record this year while housing starts are running at a 17-year high. But housing's robust run may be coming to an end. What that means for the economy is that housing will no longer be the bright spot that it has been over the past few years. For instance, in the first half of this year alone, residential construction, which is less than 5% of total gross domestic product, accounted for 16% of total growth. And the increase of 103,000 construction jobs over the past year marked one of the few sources of hiring in the bleak job market. In addition, gains in housing wealth have offset stock market losses, enabling household net worth to begin climbing again.

Housing won't collapse. Real estate is not in the midst of a bubble that will rapidly deflate once pricked. But a shift in fundamentals suggests housing is hitting a plateau in the second half and then will gradually slow in 2004. First, mortgage rates are no longer falling as they have over the past three years. If anything, they are likely to rise a bit next year. Second, homeownership is at a record high, suggesting little pent-up demand to lift sales. Finally, because home prices are outpacing gains in pretax income, affordability is becoming more of a concern, especially within the sector that's key to expanding the housing market: first-time buyers.

WHY WAS HOUSING able to fly so high for so long, even as other sectors were struggling? Give credit to the Federal Reserve and the bond market. Since early 2001, the Fed responded to weak demand by aggressively cutting short-term interest rates, and bond yields followed those rates lower. In mid-2000, the rate on a 30-year mortgage was running as high as 8.64%; today's rate is hovering around 6%.

Cheaper mortgages opened the housing market to more buyers. At 8.6%, a buyer needed an annual salary of \$4,770 to qualify for a \$200,000 mortgage. At 6%, the same requirement falls to \$57,500. In fact, lower mortgage rates are the sole reason that homebuying is more affordable now than a year ago.

House hunters have responded strongly to the fall in rates. Sales of existing homes have been increasing all year. In August, they jumped another 5.5%, to a record

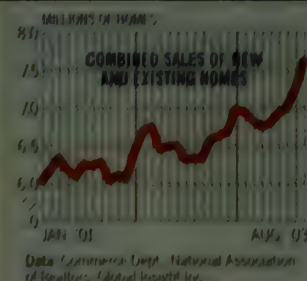
annual rate of 6.47 million. New home sales in August increased 3.4%, to a 1.15 million pace, just shy of the record set in June. Both new and existing home sales are on track to set record levels this year (chart).

The continued gains in sales have drawn down the inventory of unsold homes. In August, builders had only a 3.7-month supply of unsold new homes. For existing

homes, the supply was 4.6 months. Both readings are near record lows. Tight supplies are why homebuilders remain busy. Although starts fell back a bit in August, home construction for all of 2003 will probably be the strongest since 1986.

However, this summer was probably the sector's high point. Sales will

HOUSING IS ON TRACK FOR ANOTHER BANNER YEAR



increase further only if mortgage rates fall significantly lower. But the current bullish performance of the economy as well as the deteriorating outlook for government finances argue against any more sustained rallies in the bond markets, and mortgage rates are tied to the performance of bond yields.

ECONOMIC STRENGTH has always been a thorn in the bond market's side because the faster the economy picks up speed, the sooner bondholders begin to worry about inflation and policy-tightening by the Federal Reserve. Right now, there is little doubt that real gross domestic product grew at a hefty pace in the third quarter. Not only are businesses spending on equipment once again, but the monthly data on retail sales, service spending, and vehicle purchases indicate real consumer spending, two-thirds of real GDP, grew at an annual rate of about 6%.

True, consumers remain wary about the sluggish job market, according to the latest reading on consumer optimism. The Conference Board's index of confidence fell five points, to 76.8, in September. But bear in mind that consumers' actions don't always follow their

sentiment. Even as confidence was slipping last quarter, household spending was increasing at one of the fastest rates in two decades.

The spending spree was financed mostly from the July tax cut and money freed up by previous mortgage refinancings. Real aftertax incomes jumped 1.3% in July and another 0.6% in August. Tax payments as a percent of personal income plunged to just over 10% last quarter, the lowest rate since 1975 (chart).

HOWEVER, WHILE THE TAX CUT is boosting the economy now, it may derail housing later on. The cuts will cause steep increases in future federal deficits, which could lead to higher bond yields. So far, the Treasury's need to borrow has not run up against private credit demands. But as the recovery builds momentum, more companies will borrow to buy new equipment. That portends a clash between public and private borrowing needs that could push up long-term interest rates.

So will bond yields jump sharply? Probably not. First, although the recovery is starting to pick up speed, the economy faces an excess of production capacity as well as relatively high unemployment. That means inflation—and inflation expectations—will remain tame for a long while. Second, the Fed has indicated quite clearly that it is in no rush to raise short-term rates.

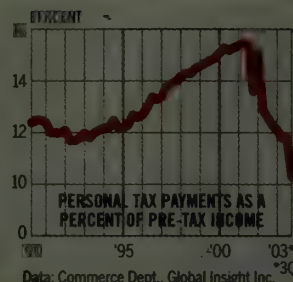
Expect some increase in long rates, though. The Mortgage Bankers Assn. forecasts the 30-year fixed mortgage rate will rise to 6.4% by next spring. Even a small rate uptick raises worries about the affordability of

homeownership, especially for first-time borrowers. The National Association of Realtors' Affordability Index dropped in August to its lowest level in a year as the summer rise in mortgage rates increased the annual income needed to buy an existing home. The NAR's index for first-time buyers, which is calculated quarterly, most

likely will show a decline in the third quarter as well, because the fall in interest rates has been the driving force for improved affordability over the past year.

Incomes, especially younger workers, have not kept pace with home prices. According to NAR data, the median income for a typical first-time home buyer rose 1.5%

HOW THE TAX CUTS FREE UP AFTERTAX INCOME



the year ended in the second quarter, but starter home prices jumped 7.4%.

If home prices and borrowing costs rise at the same time, as they seem likely to do next year, more buyers will be shut out of the housing market. The resulting drop in home construction and sales would be the first yearly decline since 2000. That means the economy's bright spot is starting to dim, and future growth will depend more heavily on consumer and business spending and exports to take up the slack. ■

BRITAIN

A Rate Hike—But Not Right Away

THE BANK OF ENGLAND is done with its latest round of interest-rate cuts. Signs that the economy is improving and concern about rapid accumulation of debt by consumers have investors betting a rate hike is not far off in the future.

The minutes from the September BOE monetary policy meeting show a shift in attitude. Responding to weaker consumer spending and fragile recoveries abroad, the central bank lowered rates by 25 basis points in July, to 3.5%. Since then, however, economic data have been rosier, leading the central bank to say the cut to "the current level of interest rates might prove to be more than was needed" to keep domestic demand going.

Indeed, second-quarter gross domestic product was revised up from an annual rate of 1.4% to 2.7%, and the third quarter is expected to be stronger. The manufacturing sector is turning around, with the September purchasing managers' factory index hitting a 16-month high. Lower interest rates also prompted a rebound in the housing market. Approved loans for home purchases

in August hit 120,000, the largest level since last October.

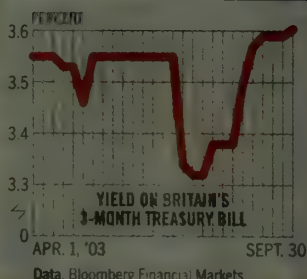
The buoyant housing market will play a role in two key areas affecting monetary policy. First, home prices are expected to slow and bring inflation down from the August level of 2.9% to a rate closer to the central

bank's current target of 2.5%. So far home prices aren't easing as quickly as anticipated. Historically low interest rates could make the process go even slower. Second, there is debate within the BOE over whether the rapid rise in mortgage and consumer debt—total lending was up 13.9% from a year ago in August—could lead to a collapse in consumer spending, thereby requiring preemptive interest-rate hikes to curb borrowing.

Investors believe a rate increase will come before year's end (chart). However, BOE Monetary Policy Committee members have been tempering the hawkish tone of the minutes from the September meeting. And BOE Chief Economist Charles Bean said the second-quarter GDP revisions weren't a big surprise to the central bank, making a move at the Oct. 8-9 meeting appear unlikely. ■

—By James Mehrling in New York

INVESTORS EXPECT A RATE HIKE



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THE JOB DRAIN

IS IT CHINA'S FAULT?

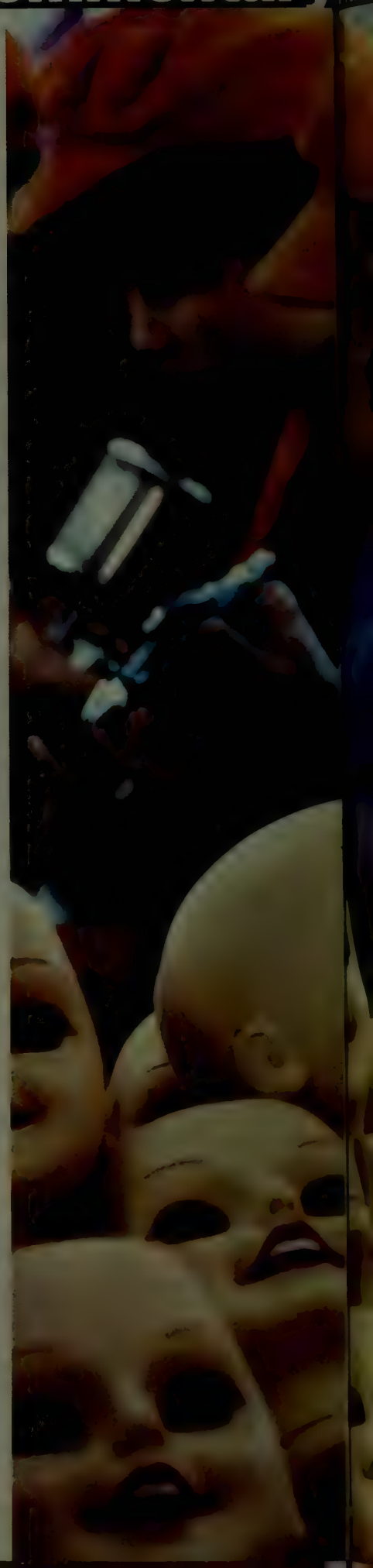
The truth is, the major reasons for U.S. job losses lie elsewhere—and a revalued yuan isn't the answer

CHINA BASHING IS ALL the rage. With millions of manufacturing jobs evaporating from the U.S. while China's trade surplus soars, politicians of all stripes are under pressure to show the folks back home that they're doing something, anything, to stem the losses. The swelling federal budget gap means that further stimulative tax cuts are out of the question. So many politicians, manufacturers, and labor representatives have pounced on China, accusing it of keeping its currency artificially low to boost exports and snatch jobs from American workers.

In Congress, moves are afoot to impose

punishing tariffs on U.S. imports from China if Beijing doesn't mend its ways. Separately, a coalition of business groups, led by the 14,000-strong National Association of Manufacturers (NAM), is planning to file an anti-China trade case with the government, alleging that it rigs its currency to gain unfair advantage. The Bush Administration has also gotten into the act. Treasury Secretary John W. Snow flew to Beijing in early September and called on China to stop rigidly controlling its currency rate, then sang a similar song at the G-7 meetings in Dubai. Administration officials say the President may repeat that refrain when he meets with Chinese leaders in Bangkok on Oct. 20-21.

One reason politicians are whipping



IN THIS SECTION:

Wesley Clark's
economic strategy

38 Who should pay for all
that drug R&D?

42 Music downloads:
Who's getting online

44 Why WaMu customers
are up in arms



SHENZHEN Chinese
exports to the U.S.
have more than
tripled since 1994

themselves into a frenzy over China is because it's an easy way to explain the constant din of layoff announcements that show little sign of slowing. From Levi Strauss, which announced on Sept. 25 that it will close its last remaining U.S. factory and lay off 2,000 workers, to Detroit, where Ford Motor and DaimlerChrysler were laying plans in early October to lay off thousands of U.S. workers in coming months, the toll continues. All told, the Big Three could shrink their workforces by 50,000 jobs over the next five years, after inking a new union labor contract.

But all the political handwringing misses a crucial point. The relationship between the world's biggest economy and its fastest-growing one in recent years can't be reduced to a single trade statistic or a single exchange rate. It's far more complex than that. Over the last decade, the two countries have become increasingly intertwined and interdependent thanks to a rapidly globalizing world economy where cutthroat competition among multinationals is the norm.

UNDER THE GUN

U.S. COMPANIES FROM Intel Corp. to General Motors Corp. face a simple imperative: invest in China to take advantage of the country's cheap labor and its fast-growing economy or lose out to rivals from Europe, Japan, and elsewhere. "It's hard to serve Chinese customers in a lot of our businesses unless we manufacture there," says W. James McNerney Jr., chairman and CEO of 3M. "We don't do it just to eviscerate U.S. jobs. We do it to be competitive." The \$17 billion maker of consumer and industrial products was the first U.S. entry to set up a holding company in China in 1984.

Still, there's no disputing that the U.S. trade deficit with China is soaring. Since 1994, Chinese exports to the U.S. have more than tripled, rising from \$39 billion to an annualized \$137 billion in the first seven months of this year. While U.S. exports have risen, too, to around \$25 billion, the resulting imbalance has led to a staggering trade deficit of more than \$100 billion.

But those numbers obscure the real story. With scores of U.S., Asian, and other companies opening factories in low-wage China, corporations around the globe are benefitting, and so are the consumers who buy their low-priced, high-quality goods. And as the U.S. trade deficit with China grows, the gap is shrinking with such countries as Taiwan, Singapore, and even Japan, which are increasingly moving factory floors to such mainland China indus-

SAN ANTONIO
Levi Strauss will shut its last U.S. plant and lay off 2,000

companies but from foreign companies, including many U.S. corporate giants.

This increased interconnectedness is making it a lot harder for Washington to get beyond anti-China rhetoric. Of China's top 40 exporters, 10 are U.S. companies, including Motorola Inc. and Dell Inc. What's more, retailers Wal-Mart Stores Inc. and Target Corp. count on low-priced goods from China to help meet U.S. consumer demand for affordable products. Wal-Mart alone has doubled its imports from China over the last five years, to \$12 billion. It now accounts for nearly 10% of all Chinese exports to the U.S. That has helped keep U.S. inflation down, allowing the Federal Reserve to cut interest rates to their lowest level in four decades. Moreover, China is helping to keep U.S. interest rates down by investing bundles of money in U.S. Treasury securi-

ties—some \$126 billion, up from \$60 billion in 2000. As a result of that shift in production, some 65% of the rise in Chinese exports since 1994 have come not from Chinese

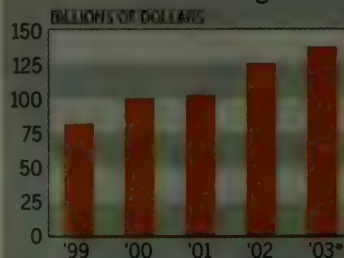
companies but from foreign companies, including many U.S. corporate giants.

The moral of all this: China is not another Japan, bent on grabbing global share for home-grown companies with mercantilist trade policies and stiff barriers to keep foreigners out of its own markets. While Beijing often talks about industrial policies, its economy is dramatically more open to trade and direct foreign investment than the old Japan Inc. Foreign manufacturers of autos, telecom equipment, and computer dominate the increasingly buoyant domestic Chinese market. China "is allowing American companies to participate in its growth," says Mustafa Mohatarem, GM's chief economist. "That distinguishes it from Japan." Indeed, China now imports more than Japan,



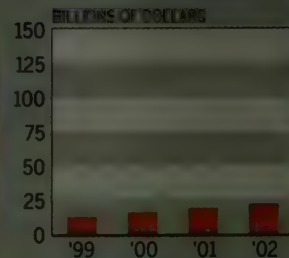
GROWING TIES

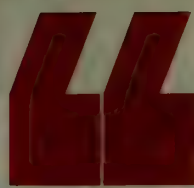
U.S. imports from China are climbing...



Data: U.S. Commerce Dept., Treasury Dept., Chinese Commerce Ministry

...but so are U.S. exports to China...





[China] is allowing American companies to participate in its growth. That distinguishes it from Japan"

—Mustafa Mohatarem
Chief Economist, General Motors

indeed be undervalued. Morris Goldstein of the Institute for International Economics, a Washington think tank, figures China's currency is undervalued by about 15% to 25%. That's not

insignificant, but it's well below the 40% figure China's critics bandy about.

BEHIND THE TRADE GAP

STILL, THE LOGIC BEHIND scapegoating China for the loss of American manufacturing jobs doesn't hold up. U.S. manufacturing employment peaked in 1979 and has been declining ever since. True, the drop has accelerated tremendously, with 2.7 million manufacturing jobs lost in the last three years alone. But a good part of that simply reflects stepped-up productivity, or, as in the case of Detroit, sales lost to the Japanese

Of course, the widening U.S. trade gap—up from \$107 billion in 1997 to \$418 billion last year—has played a part in manufacturing's swoon. But here again, China isn't to blame. The biggest

rise in the U.S. deficit over the last five years has come not with China but with the European Union. What's more, as even the NAM concedes, it has been a shortfall of exports rather than a boom in imports that has been most responsible for the growing U.S. trade gap. Over the last two years, U.S. manufacturing exports fell by \$85 billion, accounting for

roughly one-third of the fall in U.S. shipments during that period, according to the NAM. Behind the plummeting exports: weak demand overseas, especially in Europe and Japan.

China, by contrast, is sucking in imports. U.S. shipments rose by over 20% in the first seven months of this year as China snapped up everything from X-ray machines to cope with last spring's SARS epidemic to steel for its booming construction business. "The Chinese were huge buyers," says Keith E. Busse, CEO of Steel Dynamics Inc. in Fort Wayne, Ind., which sold 180,000 tons of light-gauge sheet steel to the Chinese in the first half of 2003.

The tighter links between the U.S. and Chinese economies means that a change in Beijing's currency policy would not be the panacea the China bashers seek. While a big rise in the value of the yuan would undoubtedly boost the competitiveness of U.S. exports, it might not have much impact on U.S. imports. "An appreciation of [China's currency] would have a negligible effect on the overall trade balance and manufacturing jobs at home," says Rich Brecher, Motorola's director for global business relations. Many of the low-tech industries the U.S. has lost to China and other countries with cheap labor are gone for good. Case in point: textiles. Levi Strauss & Co. was among the last to keep some production at home.

There's a lot at stake in getting the U.S. relationship with China right. Following its accession into the WTO in 2001, the country is on course to open its economy and markets to foreign competition. It's up to Washington to encourage China to continue down that path. Bashing Beijing over mutually beneficial bilateral trade is not the way to go. ■

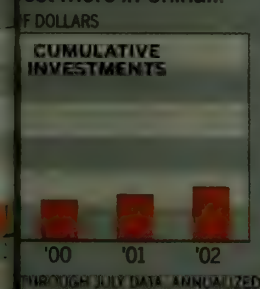
—By Rich Miller in Washington and
Pete Engardio in New York, with Dexter
Roberts in Beijing, Michael Arndt in
Chicago, and bureau reports

though its economy is one-third the size.

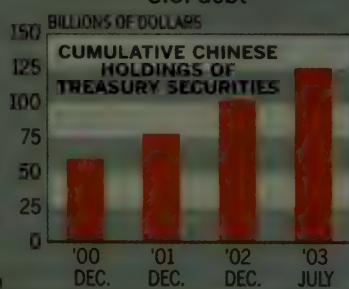
That doesn't mean China is an ideal trading partner. After getting off to an impressive start in meeting its commitments to the World Trade Organization, China's compliance has begun to flag. Foreign investors can now sell policies directly to Chinese consumers, for example, but the entry cost is steep. Foreign insurers must invest at least \$20 million in capital to set up shop. While tariffs and import quotas have fallen for farm goods, U.S. agribusiness outfits still must overcome complex export-licensing procedures. And while China has enacted important laws protecting intellectual-property rights, piracy of software, music, and movies remains rampant.

Moreover, China's currency may

U.S. companies invest more in China...



...and China snaps up U.S. debt



COMMENTARY

BY STAN CROCK

Iraqi Debt: Fast-track the Restructuring

The staggering load must be lightened, and quickly, to ensure a recovery

LURKING BENEATH the furor over continued casualties and the lack of even basic services in Iraq is a sleeper issue that could prove just as important to the nation's future: Iraq's crushing debt load, estimated at \$216 billion.

Without substantial relief—and soon—any new government would start out a financial cripple, unable to tap global

markets or the World Bank for new capital, and overly dependent on the largesse of the U.S. and other donors.

So how much should Iraq repay—and who should get it? From superhawk Richard N. Perle on the right to Britain's Jubilee Research on the far left, calls grow for renunciation of Iraq's loans, war reparations, and oil exploration contracts signed after the invasion of Kuwait. "The debt accumulated under Saddam should be forgiven entirely because it did not benefit the people, and they should not be burdened with it," Perle says. On the other side, creditors such as the Gulf States, France, Germany, and Russia say the potentially oil-rich country should pay most of what it owes.

The issue is a flashpoint in Congress, where some are incensed at pouring billions in taxpayer funds into Iraq while nations that opposed the U.S. invasion get debts paid. They would add to Iraq's burden by converting \$20.3 billion in American reconstruction aid into a loan. "In the long term, Iraq will be a prosperous nation and has the ability to repay America a portion of these costs," said Senator Susan M. Collins (R-Me.) at a recent hearing.

DANGER None of these alternatives is workable. Writing off all the debt because the Saddam regime was odious would set a precedent that could be used whenever any corrupt dictator is ousted. (And again, when the coup leaders are in turn deposed.) "You have to worry about the danger to the international financial system if you allow countries to renounce debt on the grounds that the previous government was not legitimate,"

warns Michael Kremer, a Harvard University economist.

But it's clear that Iraq can't service its current debt—and the U.S. should not add to it. Today, Iraq's debt amounts to perhaps 10 times its gross domestic product. German reparations after World War I were only double GDP yet proved so oppressive they helped spark World War II. And there's plenty of precedent for slashing a nation's debt when it becomes too onerous. The Paris Club, a group of major country creditors, trimmed the Federal Republic of Yugoslavia's burden by two-thirds in 2001. Poland and Egypt both got 50% writedowns a decade ago.

NO CHOICE Iraq may need far more relief. Former U.S. Treasury official Edwin M. Truman, now at Washington's Institute for International Economics, calculates that, with projected \$20 billion in export earnings, Iraq could service interest—but not principal—on \$80 billion in debt. But even that 60% haircut may not be enough. Will creditors accept less than that? "They don't have any choice," Truman says. "It's not as if anybody is going to get paid very much."

The world community is slowly coming to that conclusion. Iraq's major creditors of Iraq have already agreed to give Baghdad a free ride until the end of 2004 on its \$127 billion or so in loans. The Paris Club and G-7 group of industrialized nations hope to complete a debt workout by that time. Finance experts say they can't move any faster because it could take months just to figure out exactly how much Iraq owes and to whom. Creditors like this slow track. If the Iraqi economy improves while they dicker, Baghdad can pay back more.

But the debt overhang can only slow Iraq's recovery.

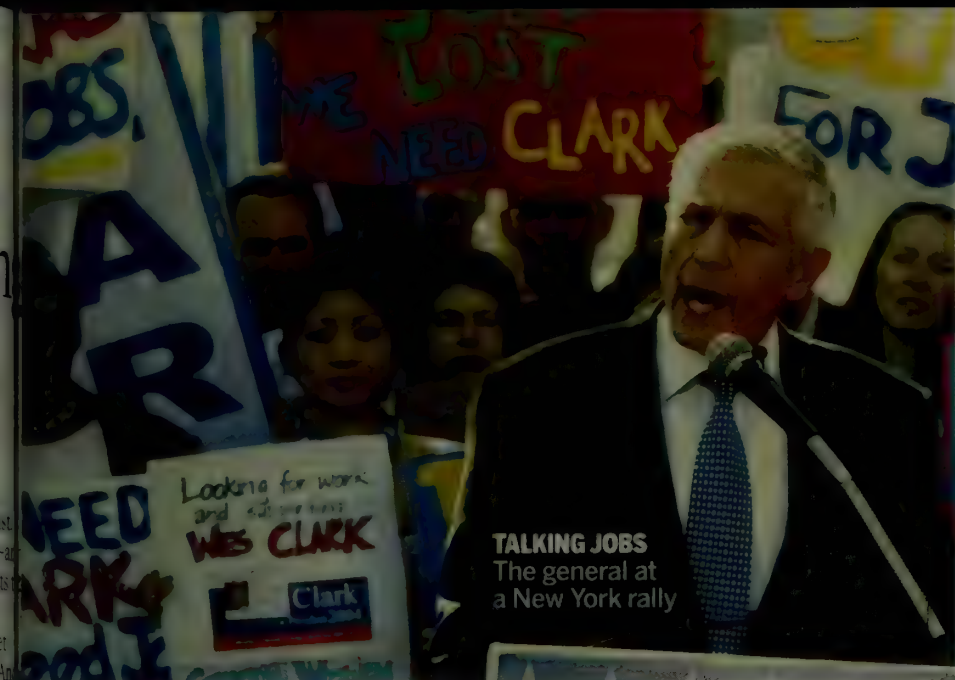
Washington must push to get the debt workout on a fast track—and must ensure that far more than 60% of the debt is eliminated. As the \$57 billion in contracts signed in the past decade, mostly for energy exploration that was to take place after sanctions were lifted, many should simply be ditched. And the United Nations Compensation Committee should whittle down the estimated \$32 billion in war reparations going primarily to Kuwait. So far, the U.S. can't guarantee Iraqis a steady source of electricity or physical security. But it can make major strides to bolster the country's financial security. ■

Baghdad's Big Bill

Outstanding Loans	War Reparations	Foreign Contracts
\$127	\$32	\$57
Billion	Billion	Billion

Data: Center for Strategic & International Studies; UN Compensation Commission; BW





TALKING JOBS
The general at
a New York rally

CAMPAIGN 2004

MARCHING DOWN THE MIDDLE

Clark sets a centrist economic agenda,
relying on former Clinton advisers

FORMER GENERAL WESLEY K. Clark has plunged into the Democratic race for President convinced that George W. Bush can be beaten. For now, Clark is riding high on little more than his war stars, which give him credibility to attack Bush on the war in Iraq. But to keep up the momentum, Clark's barebones Little Rock staff and a far-flung band of informal advisers are scurrying to create an economic agenda.

What will Clarkonomics look like? A lot like Clintonomics. Clark wants to position himself as a centrist well to the right of liberal Howard Dean. The main points of Clark's economic vision: boost international trade, trim the budget deficit, roll back President Bush's tax cuts for the wealthy, and use a mix of spending and targeted tax breaks to create jobs in the short run. "He's got good instincts on fiscal discipline and open markets," says a Washington veteran who has advised Clark on policy. "But he knows the issues better than the political nuances."

Clark briefly taught economics at West Point in the early 1970s, but he has a lot of catching up to do. So far, he has been getting much of his advice from Clinton Administration veterans, including former Treasury Secretary Robert E. Rubin, ex-National Economic Council head Gene Sperling, and former Council of Economic Advisers Chair Laura D'Andrea Tyson.

It's no surprise that Clark embraces the sort of progressive centrism that defined Clinton. Rivals such as Senators John F. Kerry (D-Mass.) and John Edwards (D-N.C.) have tried to stake out a similar position, but to little effect. Clark, who was an investment banker after retiring from the Army in 2000, is about to take his turn. Here's how he'll try:

»»ROLL BACK THE TAX CUTS Unlike Presidential hopefuls Dean and Representative Richard A. Gephardt (D-Mo.), who would repeal all of Bush's tax cuts, Clark would cut only those tax breaks for families making \$200,000 a year or more. Ending those breaks would generate about \$50 billion a year in 2004 and

Middleware. It's in the bank.

2005 and \$900 billion through 2013.

The plan is drawing fire from Republicans, who say Clark will boost taxes on small business. But the rollback would give Clark the money to accomplish several other goals, including beefing up homeland security, paying for a health-care initiative and other domestic spending, and reducing the deficit.

► **IT'S STILL THE ECONOMY, STUPID** Top on Clark's list is an economic stimulus plan. Clark would use \$100 billion over the first two years, including \$40 billion to boost investment in homeland security and infrastructure such as roads and hospitals. A further \$40 billion would help hard-pressed states in education and health care; and \$20 billion in tax breaks would encourage companies to purchase new equipment, hire workers, and keep manufacturing jobs in the U.S. But \$50 billion a year is not much money in a nearly \$11 trillion economy. And Clark would simply replace Bush's mostly supply-side tax cuts with an equal amount of demand-side spending.

► **ATTACK THE DEFICIT** Clark would use some revenues generated by his upper-bracket tax hike to fund a still-evolving health-care plan and other initiatives. The rest—maybe \$500 billion—would go for deficit reduction. But even that would trim cumulative deficits by just 10% over the next decade, according to private estimates. And it is unlikely that candidate Clark will roll out a specific plan for long-term fiscal balance. Such a proposal would require even bigger tax hikes, as well as sharp cuts in popular programs such as Medicare—issues that candidates are loath to tackle.

► **KEEP ON TRADIN'** Clark is a Clintonesque free-trader who backs existing accords such as NAFTA and the World Trade Organization. But he would insist that new agreements satisfy international environmental and labor standards, and he opposes fixed exchange rates in countries such as China—a policy that would boost U.S. exporters.

For Clark's Presidential campaign to succeed, he must first convince primary voters that his mix of market-oriented economics and deficit reduction can create jobs and solve social problems. That sort of zig to the center worked for Bill Clinton a dozen years ago. Clark is betting it will work again. ■

—By Howard Gleckman, with Paul Magnusson, in Washington

COMMENTARY

BY JOHN CAREY

Drug R&D: Must Americans Always Pay?

It's time for other countries to share the burden

IF AMERICANS WANT A REASON to be mad at Europe and Canada, they need only look at drug prices. U.S. consumers shell out \$82 retail for a month's supply of the antidepressant Zoloft, for instance, while Canadians can get it for \$42 and French patients pay just \$29. That's too great a disparity, says Dr. Mark B. McClellan, commissioner of the Food & Drug Administration. With retail prices that typically average twice those of other developed

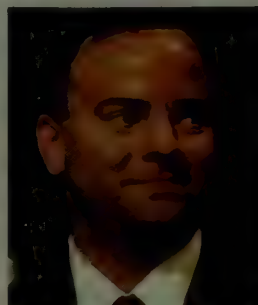
nations, "the U.S. is paying the lion's share of the cost of developing drugs," McClellan told *BusinessWeek*. "That is not a sustainable or fair situation."

He's right. And it's not just that the higher prices Americans pay for drugs fund half of the industry's research efforts. U.S. taxpayers also support most of the world's government-funded basic biomedical research—as much as 80%, by some estimates. So if it weren't for U.S. dollars, many breakthrough drugs simply would not exist. "Currently, the innovation in the pharmaceutical industry is paid for by the U.S., and, to a lesser extent, by the U.K., Switzerland, and Germany," says industry economist Eugene M. Kolassa. Although there's no clear strategy yet for sharing the burden more equally, the world would clearly benefit from broader support of research and development. In a Sept. 25 speech to a drug industry conference, McClellan urged other rich nations to raise drug prices. "If we do not find better ways to share the burden of developing new drugs," he said, "all of us will suffer."

Why the big price differences? In much of the world, governments either set prices or have so much bargaining power that they can force big discounts. The U.S. market is more chaotic. Big buyers such as the government and HMOs can often negotiate low prices that rival those found in Canada. To make up for the discounts, though, the industry charges high retail prices. So those who are least able to pay—the uninsured—are often stuck with the biggest bills.

The resulting hit on Americans' pocketbooks has led to a major revolt. If Congress manages to pass a

Medicare bill, it's likely to allow Americans to import cheaper drugs from Canada. Meanwhile, several governors have vowed to cut their states' expenditures by buying drugs from our northern neighbor. And storefronts and Web sites offering cheaper drugs from elsewhere are multiplying. "The Internet pharmacy business has mushroomed to a level where there is almost no going back,"



McCLELLAN The FDA chief is urging other rich nations to raise drug prices

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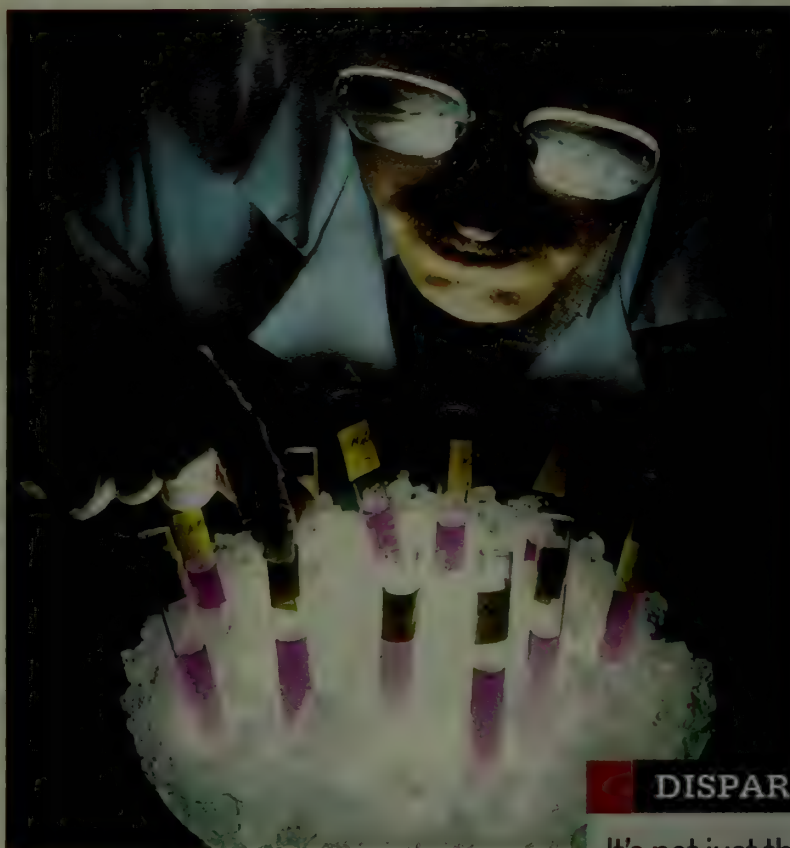
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says independent drug industry analyst Hemant K. Shah.

A big influx of cheaper drugs may seem like good news to American seniors struggling to afford their medicines. But the future it augurs is grim. There's a serious safety issue, for one thing. Already, FDA inspectors are finding that drugs being imported aren't what they claim to be. On Sept. 29, the agency announced that 88% of 1,153 drugs inspected at ports were formulations that lack U.S. approval.

TRADE-OFFS More important, if prices are lower today, then inevitably research budgets will suffer. That means there will be fewer breakthrough drugs tomorrow. Of course, many would argue that the drug industry's profits are too high, that companies spend too much on marketing and "me-too drugs," or that they should make their existing drug development operations more productive. Big Pharma also has done a lousy job making the case that many expensive new drugs do offer good value—and cut overall health-care costs.

But that doesn't change the underlying fact that higher profits means more research and development—and that paying more now offers the hope of big savings later. Imagine, for instance, the billions of dollars that the health-care system could avoid spending in coming decades if drugmakers found ways to treat or prevent Alzheimer's disease. "People don't believe it, but if all prices were the same as Canada's, there would be fewer products," says Ian Spatz, vice-president for public policy at Merck & Co. "There is a trade-off of today against tomorrow." Economists also argue that the prospect of lower prices and lower profits would cause the industry to put more of their R&D dollars

DISPARITY

It's not just that the higher prices Americans pay fund **50%** of the industry's research efforts. U.S. taxpayers also support as much as **80%** of the world's government-funded biomedical research.

into safer "me-too drugs" instead of targeting riskier breakthroughs.

Already, Europeans are fretting that their relatively low prices are killing their pharmaceutical industry. In 1990, European and U.S. companies each held about one-third share of the world drug market. Now, Europe's share is down to 21%, while the U.S.'s has jumped to 50%. European companies have increasingly moved their R&D operations to the U.S., and they make 60% their profits in the American market, analysts estimate. "Europe remains less attractive for R&D investments, primarily because its economic environment is less favorable than in the U.S.," explains Sir Tom McKillop, CEO of AstraZeneca PLC. In an attempt to turn things around, the European Commission has recommended that Europe replace regulated prices with a market system—and the recommendation is expected to pass.

NO EASY SOLUTIONS It's a promising development, but just a beginning. In addition, the U.S. desperately needs Medicare drug benefit and other subsidies so that senior and poor Americans can get the drugs they need. That would reduce the urge to import drugs from countries with lower prices. Beyond that, the industrialized world needs to acknowledge that breakthrough medicines won't be developed unless the industry can reap sufficient profits—and to figure out a way to share the burden more fairly.

There aren't any easy solutions. Before broaching the topic in his speech, FDA Commissioner McClellan had spent several months exploring possible approaches—including going to the World Trade Organization—to boost drug prices in other nations. So far, no strategy has emerged—and neither Canada nor the European Union is exactly volunteering to go first. "It's a challenge," admits McClellan. "I didn't say we have all the answers yet." The Bush Administration's Council of Economic Advisors and other White House economists are receptive to devising a plan, but trade negotiators are more doubtful. "There's no obvious way for the U.S. to take action against other nations that have price controls," explains Claude Barfield, director of trade and science and technology studies at the American Enterprise Institute.

Still, McClellan's arguments have struck a resonant chord in some countries, such as Germany, which also feels that other European nations are paying unfairly low prices.

Easy answer or not, this is too important an issue to ignore. McClellan and the Administration plan to set up a multi-agency task force to explore potential strategies for making drug prices more equitable around the world. With medicines for dread diseases such as AIDS, trade negotiators have already hammered out agreements to lower prices in countries that can't afford the expensive drugs the West produces. Now, the world's rich countries need to extend the idea of matching prices with ability to pay to their own markets. If the world wants to enjoy the future health benefits of drug R&D, it must share the cost. ■

—With Laura Cohn in London,
Jack Ewing in Frankfurt
and Joseph Weber in Chicago



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E-COMMERCE

TUNING UP LIKE NOBODY'S BUSINESS

Making a buck selling music online will be tough, but a raft of sites are at the ready

FOR YEARS, RECORD COMPANIES squelched efforts to sell tunes online, for fear of Napster-style piracy. Now, suddenly, the floodgates are opening. Giants ranging from Dell and Sony to Amazon.com and Wal-Mart are scrambling to set up Web music stores. So are a number of smaller players including—yes—a revived Napster, which is being relaunched by Roxio Inc. this month. Also within weeks Apple Computer Inc. will likely go ahead with the much-anticipated launch of its iTunes online store for Windows users. “Within a very short period,” says Dell Inc. CEO Michael Dell, “the labels will want to be on as many music stores as they can.”

With at least a dozen players likely to enter the market over the next few months, competition will be fierce. Just as the real world has everything from Wal-Mart to the indie record store, the new entrants are looking to carve out niches. Two classes of winners will likely emerge: those with sufficient scale to convert meager per-song margins into meaningful profits and those that use music to sell add-ons, be it hardware, subscriptions to online music magazines, or concert tickets. Says Jonathan Hurd, a vice-president with management consultant Adventis Corp.: “The ones that get the customer experience right will benefit—but there are many ways to mess up.”

To avoid that fate, the new services will largely mimic the business model Apple



created for its popular iTunes site. Most will sell songs for 99¢ apiece. Users will be able to burn the songs to as many CDs as they want and play them on up to three PCs or mobile devices. Music execs hope that will provide listeners with the flexibility they crave while preventing mass copying and file-sharing.

TOUGH ECONOMICS

BUT EVEN AT 99¢ a song, making profits selling music online could prove tough. Under existing arrangements, 75¢ or so will go to the label, and credit-card processors will pocket another 5¢. That leaves just 19¢ for marketing, technology, and all

other costs. The rush for market share will almost certainly force services to slash prices—and to find other ways to make money. Earlier this year, Listen.com experimented by charging 49¢ a song but ultimately retreated to 79¢—and only those with a \$9.95 subscription.

So why the rush to jump in? For hardware giants such as Dell, Sony, or Apple, the real money will be made selling music players. Dell is clearly counting on its online music offerings to create demand for its new player, the DJ, set to launch this month. And for Wal-Mart, which accounts for 20% of all music sold in the U.S., it's too big a market to ignore.

Smaller players are counting on selling premium content. For a monthly subscription of \$5 or so, customers of Musicmatch Inc. and Napster 2.0 will get a range of perks—such as exclusive recordings or the ability to easily buy a song they've heard on a Web radio station.

Whatever the model, getting downloaders to pay for online music will mean giving them sufficient control over their songs. Already, there are signs that the labels will be slightly less flexible with the vast Windows universe than they were with Apple; with 2% of the market, it was less of a piracy concern. Industry insiders say that to discourage users from sharing playlists (for instance, dance or jazz

tunes, EMI Group PLC has forced the services to reduce the number of playlists consumers can burn to a CD to five, for example. That's down from 10 at iTunes.

Other limitations could also give music fans pause. Many new songs won't be available, and acts such as the Beatles won't be online. Different services, moreover, will use different technologies to ensure customers don't cheat on copying or downloading. Without standards, users will find their portable players won't play songs from every online service.

Still, a year from now, many kinks will be gone. The best services may match the elegance of iTunes, and prices will probably have dropped.

That's the best news music fans have heard in a long time. ■

—By Peter Burrows
San Mateo, Calif., with
Ronald Grover in Los Angeles, Jay Greene in Seattle, and bureau reporter

Legit Downloads

A dozen sites are set to launch. Among the most common features:

FLEXIBILITY

Nearly unlimited CD burning and rights to play songs on three PCs and portable players

CHOICE

Up to half a million songs from multiple labels—both mainstream and independent

EXTRAS

Premium options include Web radio stations with one-click music buying

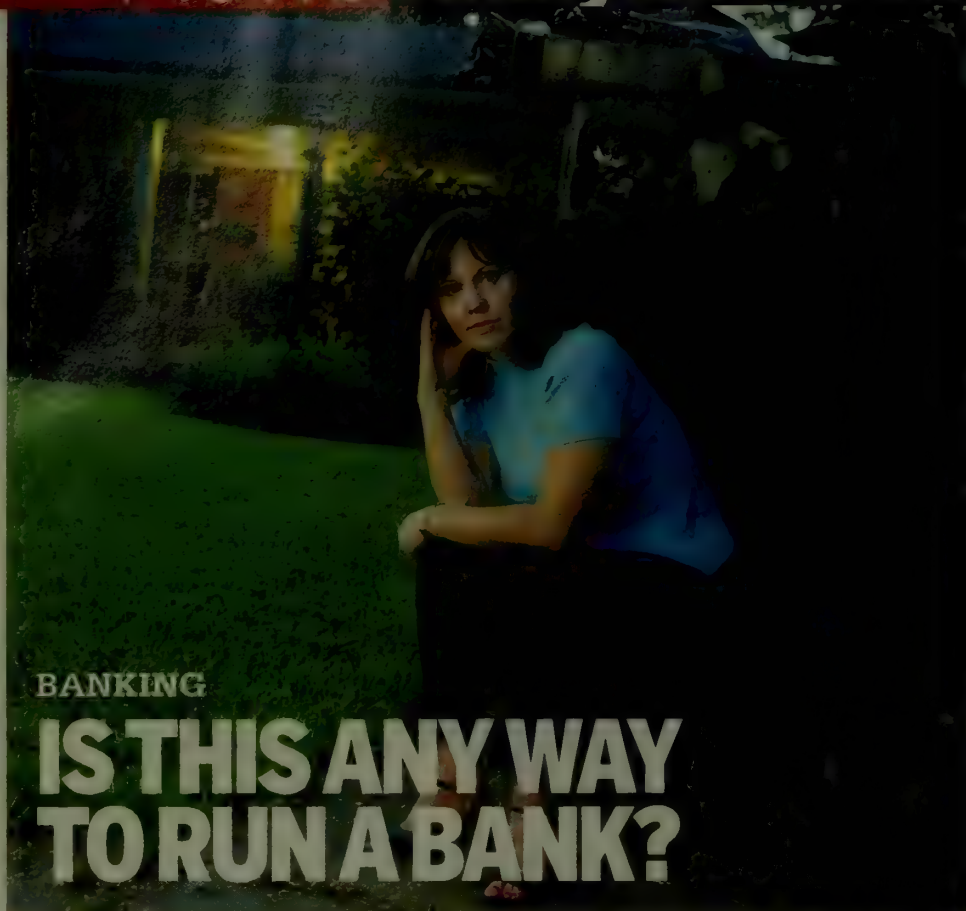


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BANKING

IS THIS ANY WAY TO RUN A BANK?

WaMu's alleged blunders have it fending off lawsuits and complaints

WHEN SHERRY COLBY decided to pay off the mortgage on her Houston house with some of the money she had collected from her insurance company for mold damage, she thought her troubles were over. Instead, she merely traded one nightmare for another. In February, she forwarded two insurance company checks for nearly \$35,000 to her mortgage company, Washington Mutual. The money went into an escrow account, and she continued to make monthly payments through July. And although she sent in the balance of the mortgage in August, by Labor Day, Colby received threatening calls from debt collectors saying she had fallen behind on her payments.

What happened? In August, Colby claims, the funds somehow vanished as they moved from the escrow account to the payoff department. Says the 44-year-old CPA: "They've lost the money."

WaMu says privacy issues prevent it

from discussing the case. But Colby is just one of scores of disgruntled customers from around the country. The fast growing, Seattle-based Washington Mutual Inc. has been fending off lawsuits and complaints in states ranging from Minnesota to Washington and California.

As the problems in Texas pile up—since mid-2002, some 200 individual consumer complaints have been filed against WaMu—*BusinessWeek* has learned that Texas' Attorney General's Office has launched an investigation into WaMu's mortgage business practices. The AG's office is looking into allegations of everything from lost mortgage payments to improper foreclosures. Fay L. Chapman, WaMu general counsel, acknowledges the bank may have made some mistakes and is reviewing each complaint individually. "We have been working co-

HOME LOAN BLUES Colby says that WaMu lost her mortgage money

operatively with Attorney General's office," she says

The dustups customers com

WaMu execs wo

turn a once little-known regional into a kind of Wal-Mart of consumer banking. Since 1991, WaMu has been a massive expansion tear as it seeks to acquire millions of new retail and home loan customers. Acquiring its way into such big markets as Texas, California and New York, WaMu now ranks as one of the nation's top thrift and mortgage lenders, serving 12.3 million households, \$283 billion in assets and 2,650 offices from coast to coast.

ILLEGAL FEES?

YET AS THE BANK HAS GROWN, so has its stable of unhappy customers around the country. Last month, Minnesota District Court Judge Steven Z. Lange granted national class action status to a January 2003, suit that alleged WaMu charged "illegal prepayment penalty fees" on borrowers paying off their mortgage loans. WaMu concedes it has charged some customers in Minnesota. In August, the bank settled a Seattle lawsuit alleging that WaMu had lost mortgage payments, posted payments late or improperly, charged erroneous fees, filed inaccurate reports to credit agencies. As part of the settlement, the bank agreed to review complaints from more than 1,000 customers. In July, a separate Seattle suit was certified as a class action involving some 150,000 customers in the Western states. It alleged WaMu "improperly collected" reconveyance, statement, and other fees when customers paid off their home loans. WaMu disputes those charges and says it will "defend

these claims vigorously

The problems have WaMu scrambling to improve its customer service and processing systems. As a result, direct complaints to WaMu have declined 35% in the first six months of 2003, and misapplied mortgage payments from April to August fell 30%, according to John Rose, WaMu's senior vice president of operational excellence. Still, if Sherry Colby is any indication, WaMu has a ways to go. ■

—By Stephanie Anderson
Forest in De

LOSING GLITTER

WaMu has racked up a variety of customer complaints, including:

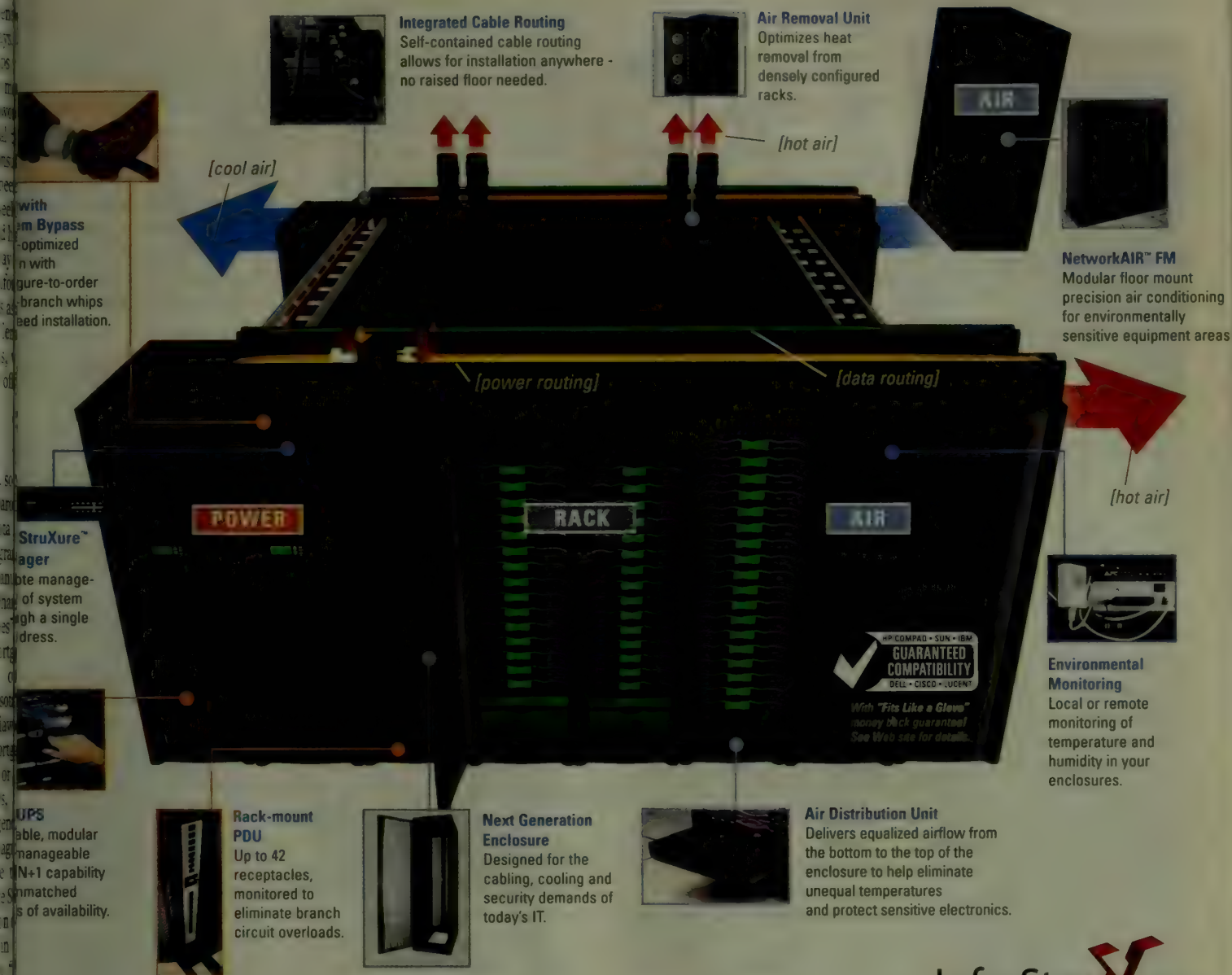
LOST mortgage payments

EXCESSIVE and erroneous fees

MISHANDLED property tax payments

INACCURATELY filed credit reports

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EDITED BY MONICA ROMAN

HEADLINER

AL GORE



MEDIA MAVEN?

Watch your back, Rush Limbaugh: Former Vice-President Al Gore, long a pincushion for right-wing commentators, is in talks to buy tiny, Canadian-based **Newsworld International** and may remake it as a left-leaning channel. Gore, whose representatives wouldn't comment, approached Newsworld owner **Vivendi Universal** in April and has offered \$70 million for the channel, say sources close to the deal. Gore, 55, who once worked as a reporter, is being assisted financially by Joel Hyatt, a co-founder of **Hyatt Legal Services**, who could not be reached for comment. **Metropolitan West Financial**, a financial-services company of which Gore has been vice-chairman since 2001, isn't involved. Turning Newsworld into a hot channel that would draw younger viewers won't be easy. The money-losing channel is seen in only 20 million of the more than 80 million U.S. homes that get cable or satellite. Still, Gore, an **Apple Computer** board member, is said to be smitten with the power of the Digital Age. Now if he could just figure out how to digitally alter Limbaugh.

—Ronald Grover

CISCO TABLES ITS CASE

One of Silicon Valley's most closely watched legal soap operas is winding down. Networking giant **Cisco Systems** has shelved its lawsuit against **Huawei Technologies**, the pride of Chinese high tech. In January, Cisco accused Huawei of such intellectual-property violations as stealing source code and reprinting pages of user manuals. At the time, Huawei agreed to address the complaints, but Cisco pressed ahead to prevent future sales of allegedly infringing products. Now, if an outside expert decides Huawei's products don't infringe, Cisco will drop its suit.

DO-NOT-CALL: WAITING

In a bizarre twist that capped a seesaw week of court rulings and political jockeying, the **Federal Communications Commission** is appealing to telemarketers to help it enforce a do-not-call list. After a Denver



District Court judge blocked the Federal Trade Commission from enforcing the registry, FCC Chairman Michael Powell stepped in, asking the Direct Marketing Assn. to provide the agency with the phone numbers of the 51 million people

who had signed up, as well as a list of telemarketers who had downloaded the registry before the court ordered it shut down. Telemarketers say they'll cooperate, but consumers shouldn't expect much relief. The FCC's enforcement authority is limited to financial-services companies, long-distance providers, and airlines.

THE ILL FEELING IS MUTUAL

More allegations of abusive trading in mutual funds are coming out of the woodwork in the wake of New York Attorney General Eliot Spitzer's case against hedge fund **Canary Capital Partners** and a broker at **Banc of America Securities**. **Prudential Securities** fired a dozen brokers and managers in Boston and New York offices Oct. 1 for their purported roles in trades at the expense of fund investors. The day before, **Alliance Capital Management** said it had suspended the veteran portfolio manager of its \$3.2 billion **AllianceBernstein Technology Fund** and a salesman of Alliance hedge-fund products. The actions came a month after Spitzer revealed schemes in which hedge funds were trading in and out of mutual funds using stale prices.

HELP FOR YAKKERS

Cell phones typically run out of gas after a few hours of use, due to energy-hungry chips. But a new chip design announced on Sept. 30 by **IBM** aims to solve that problem; it could also help enable such applications as movie-quality video streaming over cell phones.

To make the advances a reality, **IBM** has taken silicon germanium chips, typically used to power communications, and combined them on a single wafer with so-called CMOS chips, the foundation for computing applications. **IBM** says the new design could hit the market within five years.

ET CETERA...

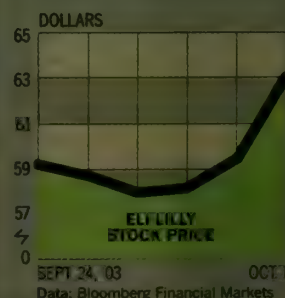
» **J.P. Morgan Chase** will pay \$25 million to settle a probe into its initial-public-offering allocation practices.

» The corporate counsel and corporate secretary of **Healthsouth** resigned.

» **Manulife** said it would buy **John Hancock Financial Services** for \$10.4 billion.

CLOSING BELL

Eli Lilly got a lift on Oct. 1 when the Food & Drug Administration gave conditional approval to its new antidepressant, **Cymbalta**. The company must pass an FDA review of its manufacturing before it can market the drug. Its shares climbed 6%, to \$63.01.



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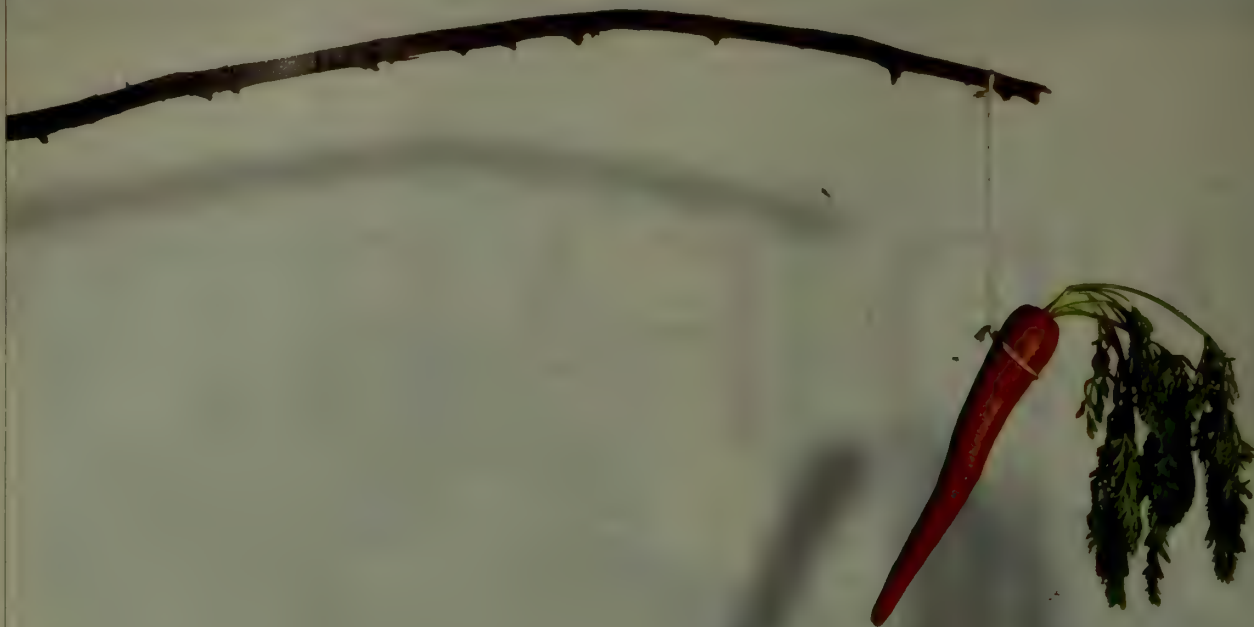
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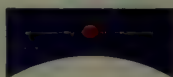
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EDITED BY LEE WALCZAK

Why the President Is in Such a Slump

CE, HE SLIPPED EASILY into the role of a Presidential Clint Eastwood, brushing aside early reports of guerrilla resistance occupied Iraq by snapping: "Bring 'em on." But nowadays, such blunt talk doesn't suit George W. Bush's increasingly somber mood. On Sept. 30, the President who has endured a

ish summer of setbacks sounded more like a chronically beleaguered Tony Soprano than a bellicose Dirty Harry. Just days after Attorney General John Ashcroft announced a criminal probe into allegations that White House aides may have blown the cover of a CIA operative in an act of political malice, Bush vowed to "take down the leakers, wherever the trail might lead. 'If the person has violated the law,' the President said, 'the person will be taken care of.'"

Finished Discipline

WITH THAT UTTERANCE, an explosive chapter in Bush's five-month slide ended—this one entitled "discipline." For weeks, the President's political stock had plunged as he has staggered from one reversal of fortune to another: a backlash over Iraq, two speeches that failed to drum up support for the U.S. occupation, mounting concerns over lost jobs, and humiliations large and small at the hands of foreign leaders increasingly hostile to Bush's vision of Americana. While critics argue that Presidents usually suffer a "third-year slump"—and that Bush's finished ratings are still strong—polls show top Democrats running neck-and-neck with the incumbent. "This is a wounded President," says independent strategist John Zogby.

This isn't the first time Bush has been in a bind, of course. But in a town accustomed to his winning ways, the setbacks are coming hard and fast: How can a White House team known for its

discipline and savvy get off track? And has überstrategist Karl Rove, who carved out an unprecedented role as the top synthesizer of politics, policy, and spin, finally started sinking after a glorious three years of walking on Washington's waters? "We need to acknowledge there are problems and clearly articulate our solutions," says one worried Bush adviser.

That's easier said than done. While Bush's crew is good at planning PR offensives—such as the carefully calibrated sales plans for the President's tax cuts—it has been unsteady at improvising. To compound the woes, Bush's bravado may be coming back to

haunt him. "He finds himself reaping the harvest of go-it-alone policies," says University of Texas political scientist Bruce Buchanan.

Allies say the President is paying a continuing price for the 2002 departure of key aide Karen Hughes, who enforced message discipline, could go toe-to-toe with Rove, and was one of the few people who felt

free to criticize Bush frankly. "The President is better with Karen around," says a veteran Bushie.

But while things may look bleak in Bush Country today, the situation could turn around if the recovery gathers steam—or U.S. troops manage to nail Saddam Hussein. Democrats now clamoring for a special prosecutor to lead the spy probe could overreach and alienate voters who still like Bush personally. At the moment, though, the weary President can't wait for his opponents to stumble. He needs to find out what's wrong with his once-formidable team and fix it—fast.

—By Richard S. Dunham



HAPPIER DAYS
Bush and former aide Hughes in 2001

CAPITAL WRAPUP

WES CLARK, INDEPENDENT MAN

PRESIDENTIAL candidate **Wesley K. Clark** declared himself a Democrat in early September, but is he really? Not according to Arkansas state law. Public records at the Pulaski County Voter Registrar's office show that the former general has been an independent since at least 1996.

Clark campaign spokesman Bill Buck told *BusinessWeek* on Sept. 29 that the candidate had updated his voter registration to reflect his new status as a Dem.

When asked to explain the discrepancy with Pulaski County records, campaign consultant Mark Fabiani said on Sept. 30 that Clark hadn't had time to register as a

Democrat but plans to as soon as he gets a breather. "This has been a whirlwind two weeks. There are a lot of things we have to do, and that's one of them," Fabiani said.

Clark's independent status only gives more fuel to rivals who have questioned his Democratic bona fides. Says Howard Dean spokeswoman Tricia Enright: "It probably takes less time to register as a Democrat than it does to register as a lobbyist." (Clark was a board member of and lobbyist for **Axiom Corp.**, a Little Rock data-mining firm.)

Fabiani says Clark's independent record—he voted for Ronald Reagan—could boost his bipartisan appeal. Maybe. But being an overnight Democrat, voting for the Gipper, and waffling on initial support for the Iraq invasion may heighten doubts about the general in the minds of the party faithful.

—By Lorraine Woellert

Clark's campaign says he hasn't had time to register

GAMES

NOKIA'S BIG LEAP

It's challenging Nintendo and Sony with a handset that plays games

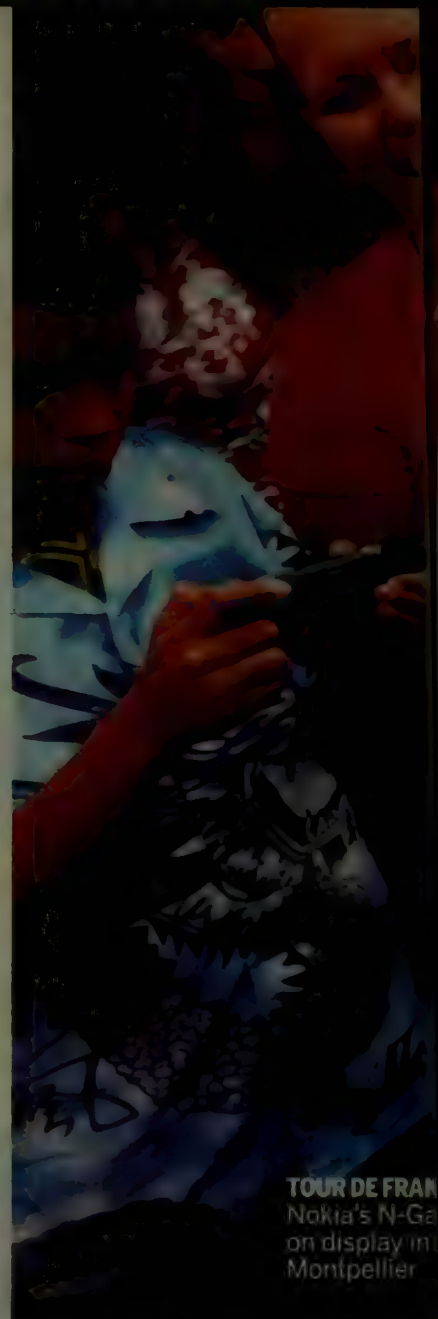
IT'S NEAR DUSK IN MILAN'S trendy Naviglio district, and the cafés and pizzerias are filling up with revelers. Drawn by the sound of blaring rock music, a stream of teenagers and twentysomethings wanders toward an 18-wheeler parked on the Piazza 24 Maggio. The truck is open on one side to reveal a stage, giant TV screens, a disk jockey, and break-dancers. But the main attraction is 40 diminutive electronic-game consoles set up for free trial runs. Visitors put the gizmos to the test, yelping with joy when they blow away bad guys and growling with frustration when they spin off a race-track into a brick wall. "I've never seen anything like this," exclaims Vincenzo Coni, an 18-year-old university student.

Milan is but one stop on Nokia Corp.'s N-Gage European tour. Cruising through 55 cities in 16 countries, it's an audacious sales pitch aimed at building buzz among young Europeans for the newest wireless gadget from the world's No.1 mobile-

phone maker. This is no ordinary Nokia phone, though. The N-Gage, which goes on sale in most parts of the world on Oct. 7 for a retail price of \$300, is a bona fide monster game machine with high-speed 3-D graphics and stereo sound—akin to a Game Boy for grown-ups, or a PlayStation that fits in your pocket. It's also a phone, text messenger, FM radio, and digital-music player.

Sounds like a cool toy, but for Nokia this is no child's play. The Finnish company is trying to crack the game industry, where one breach of coolness protocol can crash your credibility. Nokia has spent tens of millions developing N-Gage and will spend another \$100 million promoting it. Now, the fate of its highest-profile launch in years is in the hands of gamers, some of whom have ranted online that N-Gage is a "brain fart." Ouch.

As it enters this land of make-believe, Nokia is tackling a whole new batch of challenges. It has to line up the world's best game producers, a famously fickle bunch. The company says it will have 20 N-Gage titles available by Christmas—including new versions of Tomb Raider and



TOUR DE FRANCE
Nokia's N-Gage
on display in
Montpellier

Tony Hawk's Pro Skater, which are expected to be the two hottest titles. But that be enough to pull in buyers? Nokia also is scrambling to get the N-Gage carried in stores that sell games, not just phones. In targeting these retail outlets, Nokia risks alienating its core customers—the mobile operators.

Such perils are hauntingly similar to those faced by Microsoft Corp. when it launched the Xbox game console

A Guided Tour of the N-Gage

GAMES, GAMES!

With a zippy processor, 3-D graphics, and a full-color screen, the N-Gage plays sophisticated games installed via memory cartridges that will be sold in retail locations.

MUSIC ON THE MOVE

A built-in FM radio and MP3 player let the N-Gage take the place of a Walkman. A \$50 memory card can store 4 to 8 hours of digital tunes. But reviewers find the interface a bit clunky.





ve that has yet to yield profits. But as Finns see it, they have no other choice. Nokia is the longtime leader in mobile communications, with a 39% global market share. But intense rivalry is sucking profits. Although Nokia is on track to sell 12% more phones this year than in 2002—an amazing 170 million units—price pressure will likely erode its overall handset revenues by 1.4%, to \$3.3 billion, figures Merrill Lynch & Co.

Heavy spending for the N-Gage launch and losses in Nokia's mobile-networks business will trim overall profits by 1.6%, to \$3.8 billion. Investors smell a commodity trap and have driven Nokia shares 20% down since December.

That's why it's so essential for the company to keep pushing out innovative products. Nokia aims to sell at least 6 million N-Gage consoles in the next two years, which could yield it more than \$1.2

billion in revenues with estimated gross margins of 45%, higher than Nokia's overall 40% average. Yet Merrill Lynch figures Nokia's total handset revenues will sag another 5% in 2004.

Hardware sales are only part of the picture, though. Nokia also has its eye on some luscious royalties. Analyst Stuart Jeffrey of brokerage Lehman Brothers Inc. in London figures that 10 million N-Gage owners buying an average of three

WING UP

Both short-range radio lets more players in a room compete against each other. By 2004, they'll also be able to enter the air with buddies in town or in another country.

GETTING AROUND

Digital navigation buttons let players move around, jump, and, of course, fire their weapons. But game purists complain the digital controls lack the finesse of an analog joystick.

TALK TO ME

Oh yeah—it's a phone, too. The N-Gage offers voice calling and text messaging on GSM networks and supports GPRS data. But critics dislike its ergonomics. Most users will likely opt for an ear bud.

GLITCHES

Critics fault the N-Gage's small screen and \$299 price. Most of all, they dislike having to open the back and remove the battery before installing a game cartridge.

games a year would spin out \$150 million annually in royalty income. Plus, Nokia starts selling its own games next year, which could earn twice as much per unit. Also next year, Nokia and third parties may start selling software from an online site to N-Gage users, everything from upgrades to new game characters. "We're building a whole new business system," says Nokia Chief Executive Jorma Ollila.

The N-Gage is Nokia's boldest move to date in its strategy to target different consumers—novices, fashion mavens, business execs, and so on. On Sept. 26, Nokia went further, splitting into four major divisions: mobile networks, general mobile

figures there are millions of people age 18 to 35 who have outgrown their Game Boys but still want to play while commuting or hanging out.

FIERCE CRITICISM

WHAT SETS N-GAGE apart from all predecessors—no surprise—is its ability to communicate. Thanks to built-in short-range radio technology called Bluetooth, it is the first handheld that lets gamers play each other wirelessly across a room. "This is without a doubt a major improvement on all the games available on mobile phones," says Marco Zanon, a 19-year-old university student who tried out the N-Gage in Milan. But mobile networks aren't fast enough yet for real-time game playing with a buddy across town. That will have to wait for 3G.

1998, Nokia started bundling a similar "time wasting" application called Sr into its phones. In 2001, it also began making phones that played similar games written in the popular Java language. With N-Gage, however, Nokia has decided to sell the games on removable memory cards rather than via over-the-air downloads. "The publishers wanted physical distribution for better control," says Ilkka Raiskinen, senior vice-president of the entertainment media unit.

This innocuous technical change changed the N-Gage story forever. It allowed publishers to develop larger games, and charge \$30 to \$40, vs. the low prices of \$5 for downloaded Java games. But Nokia's tactic was a blow to carriers, who are enjoying a boom

in Java game sales. Though they can't sell N-Gage titles in their stores, operators can't rake in charges from downloading games.

Then there's competition. Since 1989, Nintendo has sold some 100 million Game Boy units, of which about 10 million are still in use. Its newest, the Game Boy Advance SP, features a clamshell design reminiscent of mobile phones and is a clear attempt to move beyond the traditional under-15 male Game Boy audience.

"N-Gage won't affect us," says Kyoto-based Nintendo spokesman Ken Toyoda. "It's not a mass market product." Of greater concern is Sony Corp., which plans to launch a PlayStation Portable in Japan by the end of 2004.

Yet even the N-Gage's fiercest critics concede it will change the gaming industry. N-Gage will not only popularize wireless links among players, it will also spur development of a new generation of multiplayer titles. Some doubters think Nokia's innovations are more likely to be successfully exploited by Sony and Nintendo. But don't tell that to Ollila. "We're in this for the long haul," he says. Spolix is like a true video-game action hero. ■

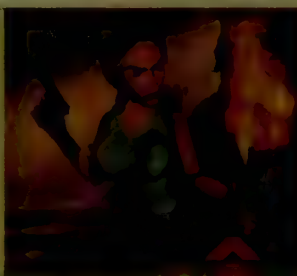
—By Andy Reinhardt in Helsinki
with Eric Sylvers in Milan and
Irene M. Kunii in Tokyo

Oof! Pow! Splat! Reviewers weigh in on early N-Gage titles

TOM CLANCY'S SPLINTER CELL

Gameloft

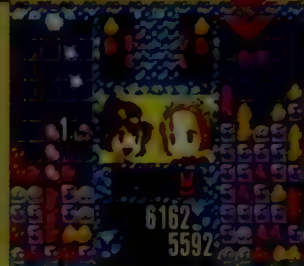
This stealth game sports snazzy graphics. To win, you have to cooperate. What a concept!



PUYO POP

Sega

The N-Gage version of this popular Japanese puzzle game adds wireless multiplayer support.



TONY HAWK'S PRO SKATER

Activision

Reviewers predict their popular skateboarding action game will be the "must-have" N-Gage title.



TOMB RAIDER

Eidos

More action adventures with the heroic Lara Croft. Reviewers think it could be a hot seller.

phones, wireless entertainment devices, and mobile business products, each aimed at vastly different market opportunities. "Strategically, Nokia is doing the right thing in trying to expand its addressable markets," says analyst Tim Luke of Lehman Brothers in New York.

Nokia has already proven it can master new businesses. Since mid-2002, it has sold more than 5 million digital camera phones in Europe, where people are now hooked on snapping, storing, and e-mailing images with a handset. That's a feat that No. 2 phonemaker Motorola Inc. is only just now trying to emulate, with decidedly mixed results. And it's not hard to figure out why Nokia picked gaming as its next frontier. With \$30 billion in annual sales, the business dwarfs Hollywood—and is growing a whole lot faster. Nokia

The criticism, however, is plenty fierce. "Trying to put high-quality games on a cell phone is like adding a TV to your washing machine," snipes Alan Caron, a 21-year-old Milan deliveryman who sports five studs in his lips and has a Game Boy at home. And game makers grumble that N-Gage players have to turn it off and take off its back cover to put in a new game. Nokia defends the design, but has already modified it in a second version of the N-Gage expected before Christmas, 2004, according to sources.

Such skepticism doesn't faze Nokia. "It's a tradition to be criticized when you enter this market," says Stefan Lampinen, Nokia's European games director, who joined up three months ago from No. 1 game software maker Electronics Arts Inc. of Redwood City, Calif. Back in

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COMMENTARY

STANLEY REED

The Labour Party's Deep Bench

Having two leaders gives it staying power

ONCE AGAIN the British press is in a frenzy over the longtime rivalry between Prime Minister Tony Blair and his Chancellor of the Exchequer, Gordon Brown. At Labour's annual conference in Bournemouth, Brown seemed poised to challenging the battered

leader with a rousing speech on Sept. 29 but barely mentioned his boss, while promising big increases in public spending. But Blair came right back the next day saying he had no regrets about leading the U.S. in the war against Iraq, and vowing to plow ahead with unpopular reforms such as introducing tuition at British universities. "I've got a reverse gear," said Blair, echoing the conservative icon Margaret Thatcher. The papers showed a glum-looking Brown apparently declining to applaud Blair's speech.

Sounds tense. But what about the speculation about a Brown-Blair feud may be that the rivalry/partnership between these two heavyweights is potentially a real source of strength for Labour. The two complement each other. The charismatic Blair has won non-Labour votes while Brown gets much of the credit for Britain's economic success, turning a Labour weakness into a long suit. And if Blair cannot recover from the furor over Iraq, the party still has a viable candidate in Brown for a second term in power.

Of course, if Brown is to succeed Blair, he will have to ease doubts over his ability to win votes outside the old Labour strongholds of the North of England, Wales, and Scotland. "Brown comes at his politics from a much more radical, progressive, egalitarian background," says Peter Kellner, chairman of the YouGov Ltd. polling organization.

Yet it would not be such a huge change for Britain if the dour Scotsman becomes Prime Minister. As part of a deal he cut with Blair, Brown already runs much of the government through his control of the Treasury's coffers. He has kept the upper hand in the debate over whether Britain should adopt the euro. What's more, Brown is seen as a more disciplined politician than the oft-waffling Blair.

Brown's other challenge is winning over Britain Inc. True, he earned the admiration of the business Establishment—and international investors—in his first term as Chancellor, when he engineered a supertight fiscal policy and

ceded the power to set interest rates to the Bank of England. But Brown shifted priorities in his second term. He hiked taxes and ratcheted up public spending to revive the National Health Service, improve schools, and shore up the decrepit transportation infrastructure.

Still, Brown can claim major achievements. The economy has grown in every quarter since Labour came to power. Unemployment is just 5%. If the numbers hold up, they will be impressive credentials for whoever leads Labour's next campaign. That leader may well be Brown. ■



GORDON BROWN
His economic success strengthens Blair

IS THAT TRUE?
THE MAJORITY OF
EMPLOYEES ARE NOT
CONTENT WITH THEIR
CURRENT LEVEL
OF FINANCIAL
WELL-BEING.



TRUE.

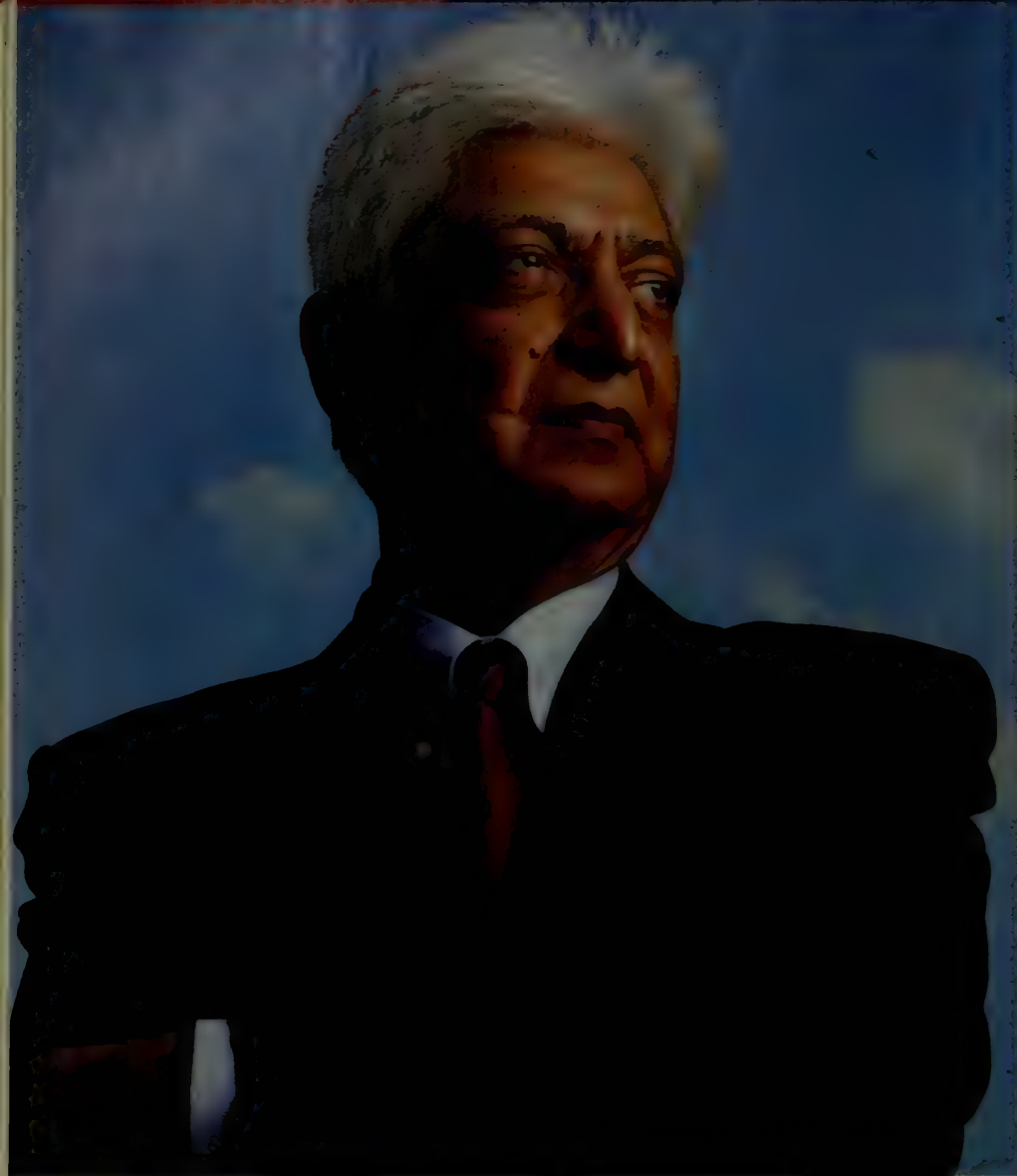
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INFORMATION TECHNOLOGY

GLOBAL DESIGNS FOR INDIA'S TECH KING

Azim Premji is taking Wipro beyond the business of writing source code

AT 4:30 A.M., A LIGHT switches on in Azim H. Premji's spacious stone bungalow in the southern Indian city of Bangalore. The 57-year-old chairman of software-services provider Wipro Ltd. is awake, fueling up on coffee and bombarding managers on four continents with e-mails. At 7, Premji walks

the quarter-mile to his office on Wipro's 12-acre campus. There, he has breakfast with visiting customers or government officials. That's followed by meetings where he focuses on the minutiae of the business—the cost of airline tickets or whether frequent-traveling Wipro salespeople should have permanent cubicles. Before the sun is overhead at noon, Premji has already worked seven hours, with another seven to go. Fre-

quently, Premji ends his day on a commercial flight—there is no corporate jet—Bombay, San Francisco, London—and where his sales team needs a boost.

An exhausting routine, followed day after day, year after year. And Premji doesn't need to do a bit of it. He owns 84% of Wipro, giving him a net worth of \$5.3 billion. That makes him the richest person in India—and one of the wealthiest on the planet. But he's not even thinking of buying a jet, or even a new car. True, Wipro, with its blue-chip roster of customers such as Microsoft, Sony, and Nokia, is one of India's top companies. The fastidiously frugal chairman, however, figures those accounts must be zealously guarded, every minute. With competition heating up as never before, the managers have to "get off their asses and get into the field," says Premji.

"EYEBALL TO EYEBALL"

THAT'S WHY, FOR ALL his success, Premji seems focused on just one goal: even more success. Wipro has grown from a small producer of cooking oil founded by his father in 1945 to a colossus by Indian standards: 23,000 employees, \$902 million in revenues, and \$170 million in profits for the fiscal year ended in March. Sales have increased by an average of 25% a year and earnings by 52% annually over the past four years. Premji "does business straight, eyeball to eyeball," says former General Electric Co. chairman and CEO John F. "Jack" Welch, who has worked with Premji as a partner and customer for the past decade.

Premji isn't slowing down. Just a few years ago, Wipro did software coding and systems maintenance. Now it's expanding into more ambitious areas, such as high-end research and helping customers design their IT systems. The firm has added 8,000 new employees in the past year, expanding its call-center services and beefing up software expertise in health care, retail, and energy.

For the growing number of white-collar workers from Silicon Valley to Sydney worried about losing their jobs to low-wage software experts in India, the ambitious billionaire is a serious threat. Yet this mogul faces the challenge of being too successful. The issue of outsourcing to low-cost destinations is becoming ever more controversial, and American politicians are calling for restrictions designed to make harder for companies like Wipro to win business. On Oct. 1, the number of visas the U.S. makes available to foreign professionals fell by 66%, to 65,000. The move

hit Indian companies as Wipro especially, since they often dis-

h engineers from India U.S. customers' offices. et premji isn't scaling his plans. His goal is turn Wipro into one of Top 10 IT-service com- ies in the world. Four s ago, he moved Wi- s tech headquarters to ta Clara, Calif., closer to company's customers,

hired Vivek Paul, a former GE Medical ems manager, as chief executive. Now on the prowl for deals that will arm pro with expertise in the lucrative tech- sulting business. In July, 2002, Wipro l \$90 million for India's top call-center ator, Spectramind. Last November, ro became the first Indian IT company ake a major U.S. acquisition, buying 100-person energy practice of Boston- ed tech consultant American Manage- nt Systems Inc. And this May the pany bought NerveWire Inc., a finan- -services consultant in Newton, Mass. big IT companies are starting to no- t. In April, Wipro beat out Oracle Corp. provide tech services to Scandinavian o TeliaSonera. "The Indians are getting y involved in these big deals, so there's e pricing pressure," gripes Oracle CEO vrence J. Ellison.

Wipro's acquisitions, though, cut oper- g margins to about 24% from 30% in past year. That has taken some of the

He's on the prowl for acquisitions in lucrative tech consulting

sheen off Wipro's stock price, which is down 24% since Jan- uary in trading on the Bom- bay Stock Exchange. The workaholic chairman does not lose much sleep over the fall. "The company is run to deliver its long-term and short-term goals, not with any view of the stock price," says Premji. Many analysts think he's right not to fret. "Though Premji's vision of acquisitions entails some

transitional pain, it will build a full-service firm that can become the model for India's tech future," says Ajay Sondhi, vice-chair- man of Kotak Mahindra Capital Co., a Bombay investment bank.

OBSESSIVE DRIVE

PREMIJI'S TRACK RECORD suggests no one should doubt his ability to fulfill his strategic vision. His father dispatched him to Stanford University, where Prem- ji—the youngest of four children—stud- ied engineering in anticipation of taking over the family business, Western India Vegetable Products Ltd., or Wipro. In 1966, while Premji was in his senior year, his father died. So the 21-year-old under- grad returned home to the dreary task of marketing cooking oil.

Wipro made good money, but Premji became restless. Then in 1977, India's so- cialist government booted out IBM, creat- ing an opening for locals to get into com- puter hardware. Premji leaped at the

A FRUGAL VISIONARY

Azim Premji

he's worth \$5.3 billion—but still drives a 1996 Ford Escort

BORN Bombay, July, 1945. His father founded Western India Vegetable Products Co., the foundation for the tech-services powerhouse Wipro has become.

EDUCATION St. Mary's School, Bombay; bachelor of engineering from Stanford University.

CAREER Took over vegetable-oil company Wipro when his father died in 1966. Expanded into computer hardware in 1981 after IBM was booted out of India. Started software in 1984.

FAMILY Married to wife Yasmeen

for 29 years; two sons, Rishad, 25, Tariq, 24.

ADMIRE: Mahatma Gandhi, Jack Welch, Bill Gates, Michael Dell.

MANAGEMENT STYLE Down-to- earth. Empowers managers and gives them autonomy, makes sales calls with marketing team, welcomes criticism but micro- manages costs and is parsimonious with employee stock options.

QUIRKS Shops at discount retailers, takes auto rickshaws from airport, does his own laundry while traveling.

Middleware. It's at the mall.



opportunity. In 1979, he began developing his own computer, and in 1984 Wipro jumped into software with a spreadsheet and word-processing package. It failed but gave Premji his first taste of the software world. "I don't agonize over failures," he says.

Premji stands out among the arriviste engineers who dominate the tech industry, combining the obsessive drive of an entrepreneur with a merchant's frugality. "Premji makes Uncle Scrooge look like Santa Claus," remarks a Bangalore tech executive. He monitors the number of toilet-paper rolls used in Wipro facilities and demands that employees switch off the lights when leaving their offices; Premji himself makes random checks on the lights at the end of the day. While on the road he does his own laundry and stays in three-star hotels—and requires his employees to do the same. There are no limos awaiting Premji when his flight touches down, and he often takes a three-wheel auto rickshaw from the Bangalore airport when returning from his travels. His only car is a 1996 Ford Escort.

RUPEE-PINCHER

WHILE SHAREHOLDERS applaud Premji's rupee-pinching, workers are less interested in roughing it—especially since they get little benefit from the boss's stinginess. Few other managers have any stake in the company, and stock options are limited. That's one reason employees leave Wipro to work for rivals or launch startups. "People will do what they are asked, but maybe not more," says a Wipro executive. "If you create, you don't get the upside."

Competing with rivals that have long-standing, clubby, boardroom-level relationships with top U.S. and European companies is tough. Premji knows he must move quickly into the lucrative consulting area and win business. "I've learned to overrespect the competition," he says. Rivals, meanwhile, are learning to respect Wipro. Global outfits have awakened to the high-quality IT services India offers. Accenture, IBM, and Electronic Data Systems are moving into the country aggressively. That will allow them to offer the benefits of India's lower costs to customers, just as Wipro does. As long as that threat remains, Premji is likely to remain sleepless in Bangalore—or wherever he happens to be doing his laundry that night. ■

—By Manjeet Kripalani and Bruce Einhorn in Bangalore

SHIPPING

MONSTERS ON THE HIGH SEAS

As China's exports swell, Korea and Japan launch mammoth container ship

IN THE SPRING OF 2000, 30 managers from Samsung Heavy Industries Ltd. gathered at the company's shipyard on an island off Korea's south coast to chart their business strategy. After a nine-hour brainstorming session, they settled on a big idea: The huge container ships that had been in use for several years were feeling a bit cramped. Why couldn't Samsung offer even huger vessels that would help shippers cut costs? "So we launched a 'jumbo container' project," recalls James Yeon, Samsung's chief marketing planner.

Their hunch was right. Hong Kong's Orient Overseas Container Line Ltd. (OOCL) soon ordered eight vessels at \$80 million apiece, each capable of carrying more than 8,000 20-foot-long containers—replacing ships that held 5,000 to 6,000 of the steel boxes. Since OOCL signed up, four more companies have placed orders for Samsung's megaships.

This fall, the super freighters will hit the seas in force, and the result could change the face of shipping. The vessels are so big—more than 1,100 feet long and 140 feet wide—that many ports will have to upgrade their facilities to ensure that their harbors are deep enough, docks long enough, and cranes tall enough to

handle them. Even so, shipping companies have ordered nearly 100 from shipyards in Korea and Japan.

PANAMA: NO WAY

THE REASON: SHIPPING GOODS on a vessel that can carry 8,000 containers is 25% to 30% cheaper than on a ship that carries just 4,000, according to Drewry Shipping Consultants Ltd., London. "You've got to have big ships to keep up with the market," says Kwok Suk Hoon, a general manager at Korea's Hanjin Shipping Co., which will deploy five megaships in 2005.

Until the early 1990s, there was little demand for such freighters because they are too big to fit through the Panama Canal. As U.S.-Asian trade grew, shipping didn't mind using larger, and cheaper, vessels to deliver to the West Coast—skipping the canal. "China's role as a global factory is reshaping transportation logistics," says Yu Yong Ho, senior vice president at shipmaker Hyundai Heavy Industries Co. Of course, the party can't last forever in the cyclical shipping industry. But for now, ship owners are happy to cruise full steam ahead, stacking even more cargo into even wider hulls. ■

By Moon Ihtw in Seoul



AT HYUNDAI: Unbeatable shipping news

Supersizing Cargo

The new ships are so big...

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One ship could carry **80 MILLION MARBIE DOLLS**

Data: World Shipping Council; Hyundai Heavy Industries

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gates can be unlocked welcome to the

Other Side

of the fence



EDITED BY ROSE BRADY

France's Economic Reforms: Fizzling Out?

IS ECONOMIC REFORM THE LATEST VICTIM of France's deadly summer heat wave? Only three months ago, Prime Minister Jean-Pierre Raffarin and his center-right government were celebrating their overhaul of the pension system. Another round of reforms looked set to get under way soon. But now

the momentum seems to have evaporated. Raffarin says he won't offer a health-care reform plan, originally scheduled for this fall, until late 2004. He's also delaying a plan to reorganize the education system. And while Raffarin had called earlier for trimming 30,000 jobs from the government bureaucracy in 2004, the budget proposal he unveiled on Sept. 25 calls for only 4,500 job cuts.

An Exodus of Support

WHAT'S SLOWING RAFFARIN down is political heat. His approval ratings have melted, from about 60% in January to less than 40% in recent polls. Although he won plaudits for facing down nationwide strikes to win pension reform, the fight cost him support. The August heat wave only made things worse: Many French say Raffarin's government bears some blame for an estimated 14,800 deaths because public health-care facilities were understaffed, and many officials were on vacation and slow to respond to the emergency.

Raffarin's friends say he hasn't lost his zeal for reform. "He's really deeply involved in the process," says Jean-Paul Betbeze, chief economist at Crédit Lyonnais. Raffarin, while pursuing some reforms, such as privatizing state-controlled companies, has resisted making deep budget cuts for fear of plunging France's economy into recession. But he's also worried about local and regional elections next March. Although no parliamentary seats are at stake, the vote is shaping up as a referendum on the government's performance since it took

power in June, 2002. Conservatives fear that if they push now for changes in health care and education, interest groups such as doctors and teachers could whip up antigovernment sentiment. The public already has doubts: A recent survey by pollster BVA showed that two-thirds of the French disapprove of the government's economic policies.

Yet Raffarin can't afford to wait much longer to trim France's costly welfare state. Although the national health-care system is supported by some of the world's heaviest payroll taxes, it's running a deficit of nearly \$12 billion this year, with spending rising 6.4% annually. The



RAFFARIN
Feeling the political heat

government has proposed a few stopgap measures, such as increasing hospital patients' out-of-pocket payments and reducing reimbursements for certain drugs. But that will save only about \$3.5 billion. To achieve bigger savings, the government would need to take far more radical steps, such as clamping down on generous prescription-drug

benefits. France already faces the threat of stiff fines by the European Union if it fails to reduce its budget deficits, which for the third year have breached the 3% ceiling set by the euro stability pact. Just as important, it risks falling behind neighbors, such as Germany, that are finally getting serious about reform. "There is political agreement now in Germany that they really have to do something," says Eric Chaney, chief euro zone economist for Morgan Stanley in London. "So far, we don't see that in France." For Raffarin, the hot spell isn't over yet. ■

—By Carol Matlack in Paris

GLOBAL WRAPUP

EUROPEAN AIRLINES: CONSOLIDATION FEVER

AFTER MARRYING to create Europe's biggest airline, Air France and KLM won't have much of a honeymoon. In a complex deal announced on Sept. 30, Air France will take over the Dutch carrier for about \$900 million. The two companies predicted the link will yield up to \$577 million in cost savings over five years and could lead to a wave of other cross-border mergers. But the deal could face close scrutiny from U.S. antitrust regulators. Air France shares plunged 11% as investors fretted that the combined carrier would be saddled with excess capacity. Unless the company takes a tough line on efficiency, it is unlikely to heighten competitive pressure on other carriers, such as British Airways and Lufthansa, to strengthen alliances with smaller carriers.

A NEW BID TO OUST VENEZUELA'S CHAVEZ

VENEZUELA'S opposition has started the ball rolling yet again to oust embattled President Hugo Chávez before next scheduled elections in 2006. On Oct. 31, opposition parties will launch a four-day signature drive to gain support for a recall referendum on Chávez's rule. If they gain the support of at least 2.4 million voters—20% of the electorate—a referendum on Chávez's presidency will likely be scheduled in February. That could lead to a presidential election in March. Chávez will no doubt use all his legal and bureaucratic powers to fight a recall vote. But he faces an uphill battle. More than 60% of Venezuela's voters say they would cast their ballot against the president.



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THE WEB MOGUL

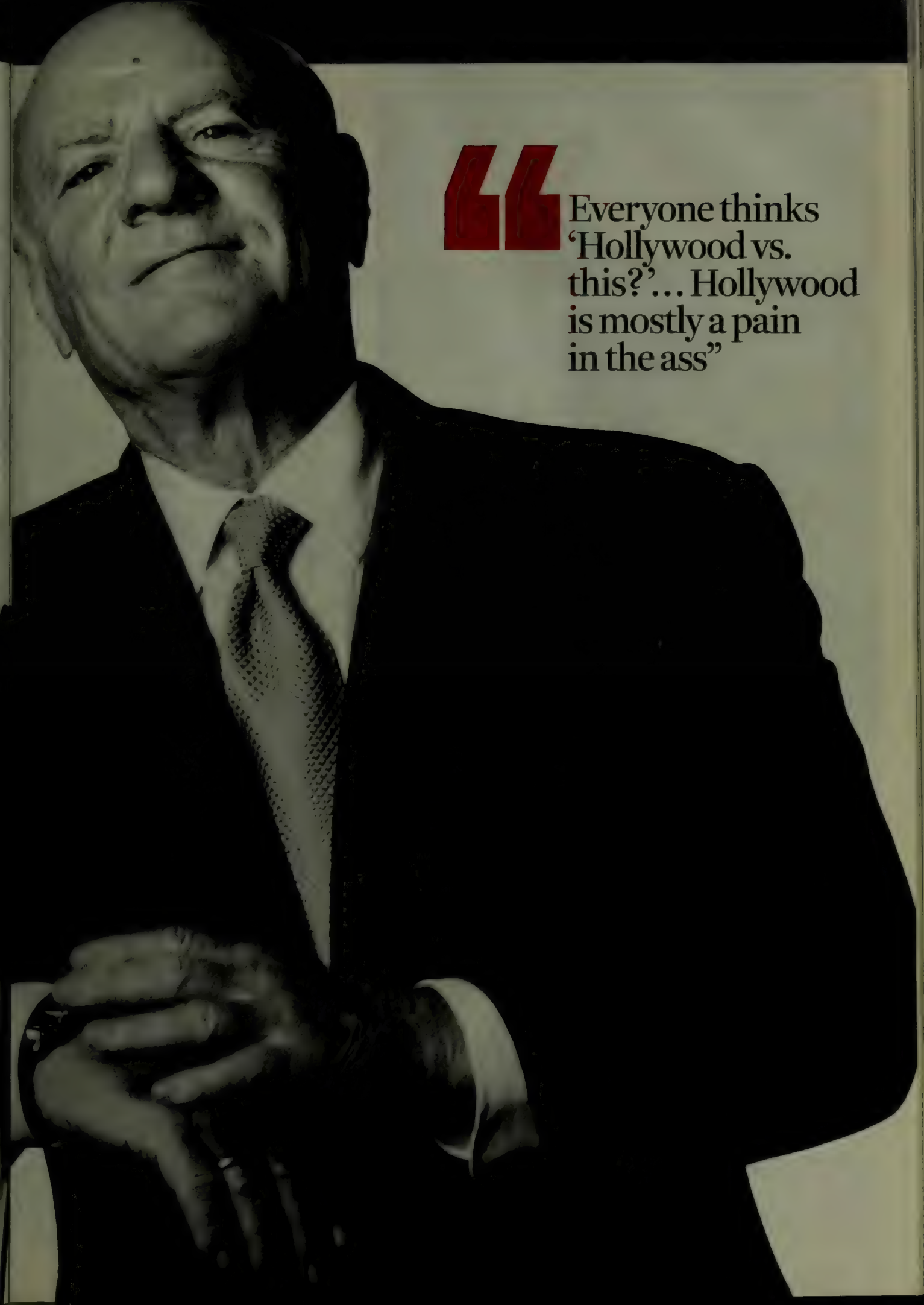
Barry Diller never had a secret plan to take over Vivendi. But he does have a not-so-secret plan to rule the Web.

BY TIMOTHY J. MULLANEY AND RONALD GROVER

IT LOOKED LIKE THE DEAL BARRY DILLER WAS BORN TO MAKE. ALL SUMMER, THE longtime movie and TV kingpin was rumored to be maneuvering to make his next big media conquest—the acquisition of Vivendi Universal Entertainment. After all, in the past decade Diller had made a play for CBS, another for Paramount Pictures Corp., and twice talked merger with NBC. But with the Sept. 2 announcement that General Electric Co. was near a deal to merge Vivendi Universal into its NBC unit, Diller once again looked like the odd man out.

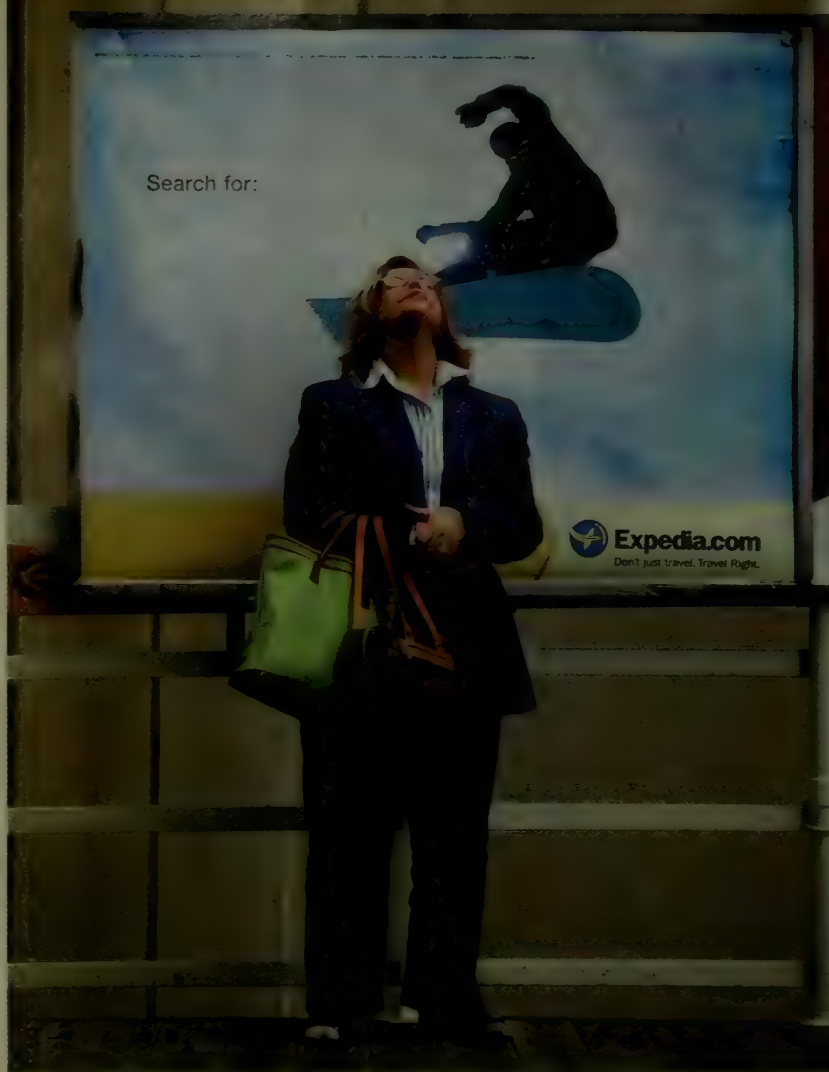
Yet the 61-year-old Diller insists there was never anything to the scuttlebutt. Sure, he had skin in the game. His company, InterActiveCorp, owns a 5.4% stake in VUE, and he personally holds an additional 1.4%. But he has sworn off Tinseltown for what he thinks is a far more promising opportunity—selling all manner of things over the Internet. “It’s unfortunate people don’t understand,”

LEN IRISH



“

Everyone thinks
'Hollywood vs.
this?'... Hollywood
is mostly a pain
in the ass”



Diller says, rolling his eyes, as he paces a conference room at his Manhattan headquarters. "Everyone thinks, 'Hollywood vs. this?' If they understood anything, they'd know this is interesting and Hollywood is"—long pause for effect—"mostly a pain in the ass."

"This" is Diller's baby, InterActiveCorp. Thanks to a two-year-long buying binge, IAC is becoming the world's largest consumer e-commerce business. With an eclectic combination of businesses, ranging from the online travel powerhouse Expedia to the Net dating service Match.com, InterActiveCorp's revenues are on track to surge 34% this year, to \$6.2 billion—which would make it bigger than e-commerce giants Yahoo!, eBay, and Amazon.com. IAC's Expedia and Hotels.com are the two most profitable online travel agencies. Ticketmaster gives him a dominating 90% share of ticket sales for concerts and sporting events. LendingTree Inc., an online mortgage-referral service, also provides an entrée into real estate. His cash cow, cable-TV retailer HSN, churns out profits he can use to throw his net ever wider on the Web.

And this relentless dealmaker, with \$5 billion in cash, is still shopping. On Sept. 21, he announced a deal to buy Hotwire.com, a Priceline.com Inc. rival, for \$665 million, giv-

Expedia's clout keeps hoteliers in line. "They have the ability to punish," says one hotel exec

ing him 3 of the top 10 most-visited travel sites cannot imagine the year will end without our making an acquisition or a series of acquisitions in the billion-or-so-dollar range," he says. He is eyeing acquisitions in travel, finance, and classified ads—and plans to push hard overseas. Ben Tompkins, an investment banker at Broadview Associates, says one attractive target is job-hunting site CareerBuilder.com.

THE BIG SQUEEZE

BEHIND THE WHEELING AND DEALING is a shrewd strategy to make IAC into something entirely new—a powerful combination of businesses focused solely on e-commerce. For this, Diller is positioning himself as a new kind of cyber-middleman. He starts by picking highly fragmented industries, such as travel, personal finance, and local entertainment. Companies intermediate between travelers and hotels, borrowers and banks, music lovers and concert halls. Think eBay, not Amazon.com Inc. Diller does not want to warehouse products like Amazon. Instead, he uses the immense power of the Web to gather boatloads of customers and deliver them, en masse, to sellers of products and services à la eBay.

What makes Diller unique is his willingness to meld the ruthlessness of a Hollywood mogul with the power of the Internet. While eBay Chief Executive Margaret C. "Meg" Whitman strives to keep the online auction site's community of buyers and sellers happy, Diller throws his weight around much like Wal-Mart Stores Inc.—squeezing suppliers so he can take a bigger slice of the pie. He grabs extra profits by giving prime billing on his Web sites to suppliers that offer him the fattest discounts, from flights to concert tickets. "In every one of our businesses, we're playing a role in defining the economic laws," he says.

Consider the killing he makes on hotels. A customer pays \$219 for a room at the Radisson Lexington New York by going to the hotel's Web site. Expedia, by contrast, demands a wholesale rate of about \$151 and then charges the customer \$189. The customer saves \$30, while Expedia pockets a 25% markup, far more than the 10% travel-agency commission that was standard before the arrival of the Net. Why do the hotels play ball? "Expedia has 1 million unique users a month—that's humongous," says Kurien Jacob, distribution director at the Radisson Lexington, which fills about 100 rooms a day with Expedia customers.

What happens if a hotel balks at heavy discounts? It must just find itself at the bottom of Expedia's list of hotels. That's what Jim Young, senior vice-president at InterContinental Hotels Group, fears would happen if the chain didn't play along with Expedia. "They have the ability to punish," says Diller makes no apology for strong-arm tactics in any of his nine major businesses. What's more, he's positioning them to feed one another, shuttling customers and coupons from one Web fiefdom to the next.

If everything works as Diller plans, IAC could be riding a gusher of profits. U.S. Bancorp Piper Jaffray analyst Sergei Rashtchy estimates that IAC's net income will nearly quadruple next year, to \$660 million, as its revenues rise 21.4%, to \$7.7 billion. That's right on par with the expected profits of everybody

DILLER'S **INTERNET** EMPIRE

IAC CEO Barry Diller says he's putting together Internet companies that will help sell one another's services and boost one another's performance. Here's how:

Companies	2003 Forecasts	Synergies	Prospects
Expedia Web travel agency	\$8.2 billion sales* 55% growth*	Expedia sells event tickets for Ticketmaster , and it's offering time shares from Interval International , an exchange for time share owners that IAC bought last year.	Already the largest online travel player, it's rapidly gaining market share as it extends its technology leadership and pours fast-rising profits into marketing. A
HSN TV and Web general retailer	\$2.2 billion sales 14% growth	Not many. HSN may promote IAC's travel businesses on the air.	A slower-growth business that has boosted profits, partly by moving 14% of its business online. It also churns out cash so Diller can acquire Net companies. B
Hotels.com Discount hotel-reservation Web site	\$1.4 billion sales* 45% growth*	Hotels.com hopes for up to \$100 million in annual sales from putting hotel coupons in Entertainment Publications' local-discount books.	It's strong now, but problems loom . Hotels.com's bare-knuckle tactics have angered hotel chains, which may play hardball when the economy recovers. B
Ticketmaster Telephone and online ticket sales	\$719 million sales 10% growth	Sells tickets to ball games, concerts, and other events to vacationers through Expedia , but the joint effort got off to a slow start.	Solid, but not flashy. Ticketmaster has upped profitability by shifting 51% of its business online. Next up: Online auctions for tickets. B
Hotwire.com Discount travel Web site	\$700 million sales* 25% growth*	Limited, at least at first, for Diller's newest acquisition. Expedia and Hotels.com will likely have links to Hotwire.com.	Solid, but Diller paid a relatively high price considering that Hotwire.com is growing slower than Expedia or Hotels.com. B
CitySearch/EPI Online city guide, plus entertainment coupons	\$269 million sales** 5% growth**	Diller has high hopes for cooperation, since Entertainment Publications' discount coupons are a natural fit with CitySearch's restaurant listings.	CitySearch has lost about \$270 million since 2001, but paid search ads are boosting results . EPI will add \$25 million to operating profits in 2003. C
LendingTree Online marketplace for bank loans and realtors	\$167 million sales 50% growth	Execs hope to bolster CitySearch , Diller's online local entertainment guide, by referring LendingTree customers to restaurants and events. But the link is tenuous.	Well-positioned as a middleman , directing customers to banks and realtors. Could take a hit if mortgage refinancings fall off. B

Source: Bookings **CitySearch results for 2003 include nine months of Entertainment Publications Inc., acquired March 25. Data: U.S. Bancorp Piper Jaffrey, Goldman Sachs



favorite Net company these days, eBay. Sure, Diller's stock price hasn't reached the euphoric levels of eBay's. It's trading at 43 times this year's projected earnings, vs. eBay's 72 (page 70). But it's still an investor favorite. IAC stock is up 45% for the year, to about \$34, compared with a 13% rise for the Standard & Poor's 500-stock index. Its market capitalization has hit \$27 billion.

But the script for InterActiveCorp hardly is assured of a happy ending. The company faces competition in nearly every market. And the most serious threat may come from InterActiveCorp's own business partners—hotel chains, airlines, banks, and others—who want to rein in Diller's ambitions, since his profits often come out of their pockets. They vow to fight back. On Sept. 8, for instance, Mandalay Resort Group in Las Vegas, a casino chain that owns the Luxor Las Vegas Resort Hotel & Casino, announced that it had pulled its top properties off Expedia and Hotels.com sites because Expedia insisted on controlling the price of the rooms sold on the Web site. "For people in the hotel industry, it was like crack cocaine. We give them rooms, and they fill them," says John Marz, Mandalay's senior vice-president. "But we lost control, and that's what everyone is trying to get back." For now, such efforts show little sign of slowing down Diller's Web express. But if he botches relations or squeezes partners too hard, resistance could grow.

LEFT COAST NAPOLEON

DILLER ALSO HAS TO CLEAR UP some accounting issues. For years, analysts have complained about the complexities of his accounting. Now he's fending off regulators in three states who say Expedia and Hotels.com haven't been collecting enough taxes on their transactions. Expedia and Hotels.com pay taxes on the amount they pay hotels for the room, not on the higher price that consumers pay them, as regulators want. In a worst-case scenario, the bill for back taxes could top \$100 million, ac-

CONSIGLIERE

"Barry said he wanted his own thing. Now he has it," says Kaufman

cording to *Business Week* calculations. too much, says Diller who says he has the reserve for the sue to less than \$1 million in the second

quarter. The company is negotiating the tax with Florida, New York, and Texas.

For now, investors don't appear concerned. That gives Diller time to avoid a quick and pensive settlement. Instead, he's throwing lawyers into the fray, hoping they can strip underpinnings from the states' case. The law in most states requires hotel operators, not travel agents, to collect the tax. Diller believes he has a solid chance of prevailing, and Wall Street analysts agree with him. But if legal tide turns against him, Diller has more than enough money to settle before the issue reflects damage on investor confidence.

The most difficult challenge for Diller may turn out to be, well, Diller. For his far-flung Web conglomerate to click, he must recruit and retain top-flight managers. Yet since he took over ABC at the tender age of 26, he has been a Left Coast Napoleon, determined to dominate with his sheer force of personality and self-admitted proclivity for micromanagement.

In the previous incarnation of his company, USA Networks, he churned through top executives like so many neckties, parting ways with a half-dozen high-profile executives, including current America Online Inc. Chief Executive Jonathan Miller. "You're worthless one week, then you're the greatest, then you're worthless," says one exec who left.

"WATCH MODE"

DILLER ADMITS THAT HIS TOUGH-GUY STYLE has drawbacks. For help, he turned earlier this year to retired GE CEO Jack Welch. Acting as a consultant, Welch helped devise a structure that lets the heads of Diller's businesses run their own operations day after day while Diller controls major issues such as mergers and budgets. Since June, when the system went into effect, "he's more in watch mode than a micromanage mode," says Robert Dier, president of Hotels.com. Although Diller admits it's a sometime struggle, he says he's keeping hands off the businesses, adding, "I don't have the time, I don't have the focus, and I don't have the depth of operating knowledge to do it."

Diller appears to be well on his way to becoming a genuine Web mogul. IAC is primed to ride the huge wave of Internet commerce, which is expected to soar from \$78 billion in 2000 to \$149 billion in 2005, according to Forrester Research Inc. The online travel business, which already provides 40% of IAC's revenues and more than half its earnings, is growing even faster—more than 30% a year. Says J. William Gurley, a partner at Benchmark Capital, the venture-capital firm that backed eBay: "If he gets leverage across the businesses, that's going to be pretty damn powerful."

Music to Diller's ears. He has aimed for the top since his early days, when he set his sights on being a Hollywood big shot. He grew up in a family of homebuilders in Beverly Hills, where his neighbors included Danny Thomas and Dean Martin. He latched on to a job in the mailroom of talent agency William

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Morris Agency in 1961, and by 1966 he had landed the top programming job at ABC. Almost overnight, Diller became a star. He was tapped for one fix-up job after another. He revived Paramount Pictures in the mid-'70s, headed Twentieth Century Fox, then ran QVC for Comcast and cable-TV kingpin John Malone.

SOLD ON THE WEB

DILLER ALWAYS DREAMED OF BUILDING his own empire. In 1994, while he was running QVC Inc., he launched a hostile and unsuccessful takeover bid for CBS. The QVC board forced his resignation for neglecting to ask for permission. So with help from Malone, he bought the Home Shopping Network and TV station group Silver King Communications, and began building a media conglomerate, USA Networks, which ultimately owned a handful of cable channels and a TV programming studio. But in the fall of 2001, six years into building USA Networks Inc., he took stock and admitted to himself that he owned a media company that was second-tier at best—and always would be. “We didn’t have enough scale on the entertainment side, and contrary to public opinion, I wasn’t driven to get it,” Diller says.

At the same time, he was drawn to e-commerce. He had awakened to the potential of TV retailing in 1992 when his friend and now wife, fashion designer Diane von Furstenberg, sold thousands of scarves in one morning on QVC. And talks with Microsoft Corp.’s William H. Gates III and Apple Computer Inc.’s Steven P. Jobs had fueled his curiosity for online retailing. But these interests remained a sideline until July, 2001, when he bought a 64% stake in Expedia, then owned by Microsoft. While other investors were giving up on the Web, Diller believed it was his best chance to establish a powerhouse. “They were inventing things, building things, and acquiring things that were not even

out of the oven, and that, for me, was very exciting,” he says. he sold his entertainment businesses to Vivendi for \$11.6 billion almost three times the \$4 billion he paid for them, cementing his reputation as one of the world’s sharpest dealmakers.

Diller now straddles two worlds. His office in L.A. sits next to Le Dome restaurant, a popular hangout with a view of the Hollywood Hills. His Manhattan conference room, by contrast, is anti-glitz. The view is of New Jersey condos, and the biggy decoration on the wall is a map of the U.S. Yet Diller is no longer conflicted over which way to go. “Barry said he wanted his own thing. Now he has it,” says Victor Kaufman, Diller’s longtime consigliere and now vice-chairman of IAC.

Still, Diller wants more of his own thing, and his clearest shot at dominating an entire industry is in travel. Since the September 11 attacks, hotels have been stuck with a glut of empty rooms, which they’re willing to sell through Expedia and Hotels.com on a wholesale basis. At the same time, Expedia is expanding into the corporate travel business, in hopes that it can gain the same kind of leverage over the airlines. The result: The two sites will likely build on their combined 23% share of the online travel business, says market researcher PhoCusWright Inc. And that’s even while online travel bookings double from their 2002 levels, to \$65 billion, by 2005, or 30% of all U.S. travel. Says PhoCusWright President Philip C. Wolf: “They’re going to be the largest travel-distribution brand on the planet.”

Hotel owners are complaining, but they lack firepower. For big hotel chains—Marriott, Hilton, Starwood, Six Continents and Hyatt—banded together to start rival site Travelweb.com last year, but Travelweb’s monthly Web audience is barely one-tenth the size of Expedia’s, and about a quarter of Hotels.com. Even the hoteliers doubt that they’ll be able to roll back Expedia’s gains. “I have never believed this will go away,” says Steve

Hankin, president of the electronic distribution unit at Starwood Hotels & Resorts Worldwide. The airlines haven’t been able to combat Expedia, either. It keeps gaining market share—even at the expense of the No.3 travel site, Orbitz which the airlines created as an Expedia killer.

Now Diller is attempting to gain the same kind of clout in other businesses. His next target: real estate lending and referrals. LendingTree, which attracts 1 million visitors every month, is angling for slices of the \$3 trillion-a-year mortgage market and the \$60 billion a year that real estate agents collect in housing sale commissions. In lending, it routes each customer’s loan application to four different banks and makes an average of about \$500 when the loan closes. In real estate, it collects a fee for matching up a customer with a real estate agent. LendingTree takes one-third of the standard 6% real estate commission, or up to \$3,530 on the median existing U.S. home sale in June of \$176,500.

Diller’s strategy is based on the notion that Web middlemen can profit handsomely simply by bringing buyers and sellers together. Changes in real estate shopping patterns strongly suggest his plan will work. A survey by the National Association of Realtors, released in Ju-

A MOGUL’S LIFE

Barry Charles Diller

He’ll take Manhattan—and Tinseltown, and the high seas



JOB Chairman and CEO, InterActiveCorp.

BORN Feb. 2, 1942, in San Francisco, to Reva and Michael Diller.

RICH GUY’S LOTTO Sold IAC’s cable networks and production studio to Vivendi Universal for some \$11.6 billion last year. The IAC stock Diller took as most of his payment is up 13% since then, while Vivendi is reselling the networks and studio at a 25% loss.

WORKING STIFF Diller’s salary is a relatively modest \$500,000, and he hasn’t taken a stock option from IAC since 1997. But he took \$275 million in stock to run Vivendi Universal Entertainment for less than a year.

HOBNOBBING With Diane Sawyer and Susan Sarandon (above)

HITCHED Married to long-time friend, clothing designer Diane Von Furstenberg.

MOVIE NIGHT Catches the latest flicks in a \$1.8 million screening room IAC built at his Beverly Hills home.

WEEKENDS Passionate skipper of his yacht, the Arriva.

ON HIS OFFICE BOOKSHELF Mostly art and architecture books, with no business or movie tomes in sight.

ON MEDIA TALES OF HIS TEMPER “I kind of like this apocryphality of my life.”



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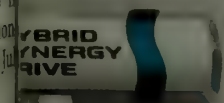
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TODAY TOMORROW

TOYOTA

showed 71% of shoppers begin their real estate search online, up from 41% in 2001. And a study by the California Association of Realtors says 23% applied for a loan pre-approval before picking a house, meaning LendingTree is likely to get a crack at millions of customers before they see a real estate agent.

Even as business booms, Diller's legendary nastiness sometimes spills out. Earlier this year at a meeting of studio executives, Diller, as part-time CEO of Vivendi Universal Entertainment, unloaded invective on Universal's studio chief, Stacy Snider, when she fumbled some numbers, say two people who were at the meeting. Vivendi Universal CEO Ron Meyer later persuaded Diller to call Snider and apologize. "It was a moment of misstatement and fatigue that he seized upon," says Snider, who adds: "It doesn't represent the other 90% of my relationship with Barry Diller." Diller admits he sometimes goes too far. "I can't say there haven't been occasions where people have been humiliated," he says.

Now, at least, he responds to suggestions. This summer, his business chiefs asked him to discontinue one of his traditions: much-hated weekly executive-team conference calls where he would invite operating unit heads to critique one another's strategies. Diller would jump in with barbed comments. When the meetings were canned, "there were cheers from the countryside," Diller says ruefully.

Is this old Hollywood hound learning new tricks? It certainly appears so. On the strategy front, he seems to be learning from the mistakes of his past. For years after he bought Home Shopping Network in 1995 and began trying to build his own company, Diller never articulated a clear vision of how all of the businesses would become more than the sum of their parts. That only fed speculation that he would chuck it all to make another run at a Hollywood studio.

These days, though, Diller seems sold on the Internet. "How could anybody not look at this as a great piece of extraordinary luck? I'm at an age, in a time, in a world, with a business with real growth in the most interesting sector of life and of business," he says.

In a sense, Diller gets to enjoy the best of both worlds. He still goes to the Oscars, still hangs out at the Cannes Film Festival, and still gets his calls to Hollywood returned, pronto. And he's in a business with nearly triple the growth and profit margins of a movie studio. Why work in Tinseltown? For Barry Diller, it's show-time on the Web. ■

COMMENTARY

BY TIMOTHY J. MULLANEY

How Diller Can Win Over Wall Street

Three moves to bolster InterActiveCorp's stock

WALL STREET LOVES Barry Diller, but

not enough, as far as he's concerned. Even though InterActiveCorp stock has risen 45% this year—and even though the

company has higher revenue and more cash flow than such leading e-commerce players as Amazon.com, eBay, and Yahoo!—it isn't as highly valued as those companies. Its price-earnings multiple of 43 pales next to eBay's 72, Yahoo!'s 100, or Amazon.com's 86. But that's partly Diller's fault: IAC's stock is held back by investor concerns about its financial complexity, shareholder dilution, and corporate governance.

Diller could strengthen the market's trust in him and in IAC with a few bold strokes. He should carve out a little time from dealmaking to simplify those reports, improve corporate governance, and do a large stock buyback to offset the 247 million new shares issued in this year's acquisition spree.

Here's what to do:

GIVE CLEARER FINANCIAL REPORTS

IAC gives skeptics ammunition by emphasizing pro forma earnings as opposed to earnings under generally accepted accounting principles. Diller's quarterly earnings analysis emphasizes a measure he calls

adjusted net income, which exclude expenses such as amortization. IAC earnings under Generally Accepted Accounting Practices are fine: Wall Street estimates for 2004 range up to \$660 million. There's no need to jazz up the story.

IMPROVE CORPORATE GOVERNANCE

Diller runs IAC as a personal fiefdom. His 11-member board is dominated by people who have had close business and personal ties to Diller, including his wife. One nettlesome sign of Diller's control is that IAC pays half the maintenance on his Los Angeles house—more than \$200,000 a year—though IAC is based in New York.

IAC needs a more independent board that will rein Diller in when necessary—and assure investors that IAC is their company, too.

BUY BACK SHARES TO OFFSET

DILUTION IAC's big Wall Street problem of late is the stock's 16% drop since Aug. 5, when Diller explained

how many shares he had issued to make acquisitions. Investors decided there were too many shares to be supported by IAC's near-term earnings. To fix it, Diller should buy back \$15 billion of IAC stock to boost the company's earnings per share.

These reforms will give IAC higher earnings quality and end question-

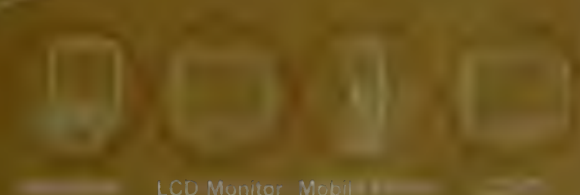
about whether Diller's company is too incestuous. Even then, IAC's stock won't get an eBay or Yahoo-like multiple: They're growing faster because IAC owns slower-but-steady Ticketmaster and cable-TV retailer HSN. But at least these steps will let IAC be judged purely on its merits. ■

It's partly Diller's fault if investors remain skeptical about IAC

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Technologies

A few years back, companies using supply chain management (SCM) technologies seemed to be channeling Henny Youngman: "Take my vendor—please!" Disappointment with the benefits produced by SCM solutions (especially those designed for planning) had certain manufacturers and retailers blaming software vendors for everything from missed sales targets to falling stock values.

But then a funny thing happened. While the economy struggled, businesses disinclined to spend on technology rethought their business processes, cleaned up their data, and focused on the mechanics of their supply chains. With this internal housekeeping underway, SCM's true value emerged: helping companies execute by automating routine ordering and inventory management tasks, electronically sharing information and collaborating with supply chain partners, and optimizing efficiencies. "Having adapted to their supply chain systems, endured lengthy implementation processes, and scaled back their expectations, many executives

are now satisfied with the benefits delivered by SCM," says Larry Lapide, vice president of research for AMR Research, Inc.



The lessons learned by early adopters are critical for businesses using or considering buying SCM today. By understanding what went wrong with early implementations, companies can not only avoid common pitfalls but also maximize the present value of their supply chain systems. It's a punch line that brings a smile to everyone's face. »

Supply Chain Technologies *continued*

How did the disappointment in SCM begin? In the mid-1990s, vendors began promoting planning software over traditional execution applications. Supply chain execution (SCE) software helps companies reduce costs and improve processes in focused disciplines such

“Technology alone is not a panacea—pure business skills make the difference between success and failure.”

as fulfillment, inventory management, and logistics. Supply chain planning (SCP) solutions tend to focus on the big picture, such as preparing for the next cycle's demand—and companies were told to expect even bigger benefits.

“Because these were brand new applications, there was an overestimation of benefits and an underestimation of the time it would take to execute,” explains Lapide.

“The average deal size was up to \$2 million; businesses spent the money up front and then had software implemented over time. It was the perfect recipe for disappointment.”

Today, as companies look for certain value, the tables have turned. SCE software makes up 63% of all SCM license revenue. AMR Research (Boston) projects that the market for execution software will grow 10% over the next five years, with SCP software growing only half that much. “Companies are no longer buying suites of planning applications, but rather single applications to address specific supply chain problems,” Lapide writes in *The Supply Chain Management Applications Report, 2002–2007*.

Execution software fills that role well. SCE applications can be implemented incrementally, tackling such trouble spots as inefficient order fulfillment or bloated warehouses—processes that tend to naturally slash inventories, reduce supply chain costs, and generate predictable benefits.

Often, the savings generated from a single SCE initiative can partially or completely fund subsequent implementations. Perhaps most important for gun-shy buyers, execution projects tend to create payback in short timeframes—nine months is not unusual.

More Than Technology



With this shift toward execution tasks in mind, how can companies wring the most value from their SCM initiatives? To begin with, executives must recognize that it's a business problem first and foremost. “Technology alone is not a panacea,” says Bob Ferrari, director of product marketing for SAP (Walldorf, Germany). “To get results, companies need powerful supply chain solutions combined with good business processes, clean data, solid project management skills, a phased-in implementation, and a strategic long-term direction. These are the pure business skills that make



the difference between success and failure.”

Moreover, organizations need firm buy-in from executive management down to the user communities who will ultimately use the SCM tools. “Supply chain projects touch everything in the enterprise,” explains Bill Michael, vice president of marketing for Roadway Express, a subsidiary of Roadway Corp. in Akron, Ohio. “You need to have senior management pushing it, but you need everyone to buy in.”

Companies then must create a strategy that identifies objectives and sets expectations. Brown-Forman, a Louisville, Ky. manufacturer of wines and spirits and consumer durables, was careful to establish its objectives

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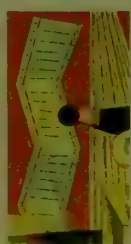


Supply Chain Technologies *continued*

before embarking on an implementation of SAP supply chain software. "We were laser-focused on reducing our finished goods inventories," says Jim Hutchinson, senior vice president and director of supply chain integration. "We saw the problems companies have when they start out with multiple, conflicting objectives."

Rethinking Processes

Organizations must re-evaluate—and often



change—their business processes in light of these objectives. Brown-

Forman had inventory in 60 warehouses around the world, yet the company's visibility into stock receipts and withdrawals was extremely limited. Extensive corporate resources were dedicated to developing forecasts, yet they provided almost no real value. Brown-Forman revamped its processes to close the visibility gaps and improve its forecasting. Now in its second year of a three-year plan, the company is com-

"Working with a vendor on system design during the bidding process can help everyone better understand the company's needs and create a more relevant solution."

fortably hitting its inventory reduction goals, and the SCM technology is meeting expectations.

Reviewing the effectiveness of existing processes—and modifying them when necessary—is critical to gaining real benefits. "There's no secret to why supply chain inefficiencies exist," agrees Pallab Chatterjee, president of solutions operations for i2 in Dallas. "Standard business processes may not be the most efficient. For supply chain improvement to succeed, companies must define their processes, identify inefficiencies, and set up the software to enhance the processes. If you merely automate existing processes, you'll simply make the wrong decisions faster."

Cybox, a manufacturer of fitness equipment, was aware that major business process changes would need to take place when it rolled out new SCM technology from PeopleSoft (Pleasanton, Calif.). "Our old sales systems would accept orders without complete information," says Brian Lyman, manager of business systems at the Medway, Mass. company. If, for example, an order for weight benches did not specify the buyer's desired color, Cybox personnel had to chase down that information. If the paint

order lead times by over 50%. Other process changes, combined with the efficiencies delivered by the PeopleSoft applications, helped boost on-time shipments to 97%, increase the order rate 15% with no additional staffing, and decrease the bill of materials count from 15,200 to 200.

The more experienced a company is with its own supply chain practices, the better the results of an SCM initiative typically are. A recent survey of 75 supply chains conducted by Waltham, Mass. manage-



was not in-house, the company had to order it. "This resulted in countless headaches, insufficient inventories that were not aligned to actual demand, and—most harmful of all—missed delivery times," he says.

By changing the process to require complete information, Cybox cut its build-to-

ment consultant PRTM found that companies with mature supply chain practices were 38% more profitable than organizations with less mature practices. When an automated supply chain planning system was used in these companies, profitability increased another 27%. »

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Supply Chain Technologies *continued*

Slice and Dice

Once business processes



have been refined, companies can begin designing

the new system—often with the help of prospective vendors. In fact, some software providers incorporate design into the bidding process to help companies get up and running faster. "Working with a vendor on system design during the bidding process can help everyone better understand the company's needs and create a more relevant solution," explains John Carr, president of global supply chain for BAX Global in Irvine, Calif. "With that task complete, we can reduce the buildup timeframe before the solution is implemented."

Indeed, overly long implementation phases have been at the heart of many cases of SCM heartburn. "You can't expect people to work on projects and not see benefits for three years or more," says Lapide. The alternative is to implement the SCM initiative incrementally—paying for each piece in turn, gaining benefits over time, and allowing

those benefits to fund subsequent projects.

"Even if it is a very large investment, businesses can go live in pieces along the way," explains Michael Hallén, president and CEO of IFS, headquartered in Linköping, Sweden. "Incremental implementation helps you to see results as quickly as two to three months. It also reduces the risk of missing your target. Think of it this way: if you set out a goal and it takes two or three years to achieve it, by then your goal has probably changed."

Tying it All Together

One of the most common challenges is integration. Although Web-enabled software has simplified inter-application communications, integration can still give experienced implementation teams pause. "Everyone assumes that integration issues are not to be worried about, but they are always

the biggest problem," says Vincent Gulisano, senior vice president of sales, marketing, and solutions engineering for APL Logistics in Oakland, Calif.

For some companies, buying SCM software from their ERP vendors simplifies the integration issue. However, some businesses need richer functionality that only point solutions can provide. "Not everyone can get all that they need from one vendor," says Lapide of AMR Research. "So it's still a big challenge to bring these systems together."

Imagistics International, a \$630 million distributor of office equipment, asked its logistics provider, BAX Global, to meet with two of its other vendors for nearly six weeks to design the integration needed to make the three systems work together. "There were many meetings and calls where we reviewed all of the integration points throughout the system,"

remembers Tom Bryant, vice president of global supply chain for the Trumbull, Conn. company. "But when we went live, we encountered very few problems."

“ People don't respond well to mandates. To get maximum leverage from a supply chain initiative, companies need to acknowledge that change management is a critical success factor and act accordingly. ”

The Human Touch

Technology is not the only challenging aspect. Managing the change introduced by supply chain technologies—and how it impacts the people who use it—is more important than most businesses realize.

"Strong communication is essential to help people understand why they're being asked to change the way they work," explains Valerie Bonebrake, executive vice president and chief operating officer for



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Supply Chain Technologies *continued*

Meridian IQ, a global transportation management company of Yellow Corporation in Overland Park, Kans. "People don't respond well to mandates. To get maximum leverage from a supply chain initiative, companies need to acknowledge that change management is a critical success factor and act accordingly."

Scotts Company understood this reality. When the Marysville, Ohio provider of lawn and garden products set a goal of doubling its annual inventory turns by becoming more customer-centric, supply chain software from Manugistics in Rockville, Md. became the heart of the solution.

Yet Dr. Sumantra Sengupta, senior vice president and CIO for Scotts, recognized that "a major mind-set change" was necessary for the initiative to succeed. "This has nothing to do with the technology," he says. "We understood that we were asking people to think differently than they ever had about their work." By intensively focusing on helping Scotts' people to understand the need for change and how the technology could drive new success, the

"This technology allows us to predict what our customers will need and give them what they want—faster and more cost-effectively than we ever could before."

company paved the way for measurably better results. Forecasting accuracy, which was once no better than 50%, is now approaching 80%—a profitability-boosting improvement.

Serious Improvements



Companies that make the effort to address these success factors can not only mitigate the common difficulties of SCM implementations but also wring maximum value from their initiatives. Alcon, Inc., an eyecare company based in Fort Worth, Tex., added a supply chain forecasting

application from SAS (Cary, N.C.) to help reduce back orders, save staff time, and optimize inventory levels. The inventory-centric company manufactures customized surgical procedure trays and a variety of consumable products used by eye surgeons; each Custom-Pak tray is manufactured to the surgeon's unique specifications and contains 30 to 35 components positioned in precisely the order the doctor will use them.

Using the supply chain analytics capabilities, Alcon was able to save more than \$6 million in inventory costs and \$600,000 in salary and benefits. "This technology allows us to predict what our customers will need and give them what they want—faster and more cost-effectively than we ever could before," says Gary Keathley, Alcon's Custom-Pak materials manager. "There's no question that the bottom-line impact has been substantial."

Getting this kind of serious value from SCM solutions is the ultimate payoff. And with these results comes more realistic expectations for the kind of value supply chain technology can deliver.

"I like to compare SCM with marriage," explains Lapide of AMR Research. "Most people head into a wedding with ideas about how the marriage will be, with a tendency to think things will be less rocky and that the benefits will be greater than they actually are. Then there's a period where reality sets in and there may even be a little disenchantment. But in the final analysis, most of these relationships survive and thrive. In the same way, we're finding that maturing supply chain solutions are delivering real value to business organizations today."

And that's the kind of benefit that makes executives smile.

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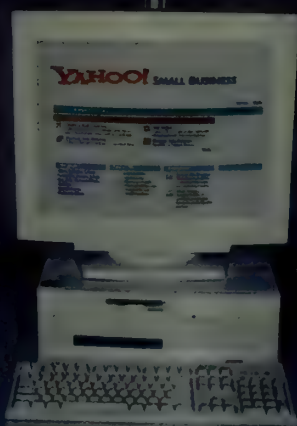
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Small Business

SPECIAL REPORT



COOKING Oven maker Wolverine Proctor & Schwartz is growing again



SMALL BUSINESS

Right Place, Right Time

Small businesses aren't just surviving. They're growing—and hiring. **BY PETER COY**

DURING THE EXPLOSIVE '90s, M. Ann Padilla got orders for thousands of temporary office workers from such pillars of the Denver business community as AT&T, Qwest Communications International, and Adolph Coors. But those aren't her most important clients anymore; they've cut thousands of workers locally. Now, Padilla says, small business is what's keeping her Sunny Side Inc./Temp Side going. Orders are coming from companies with 10 to 100 employees: construction contractors, distributors, nurseries. And they're picking

SHAWN G. HENRY

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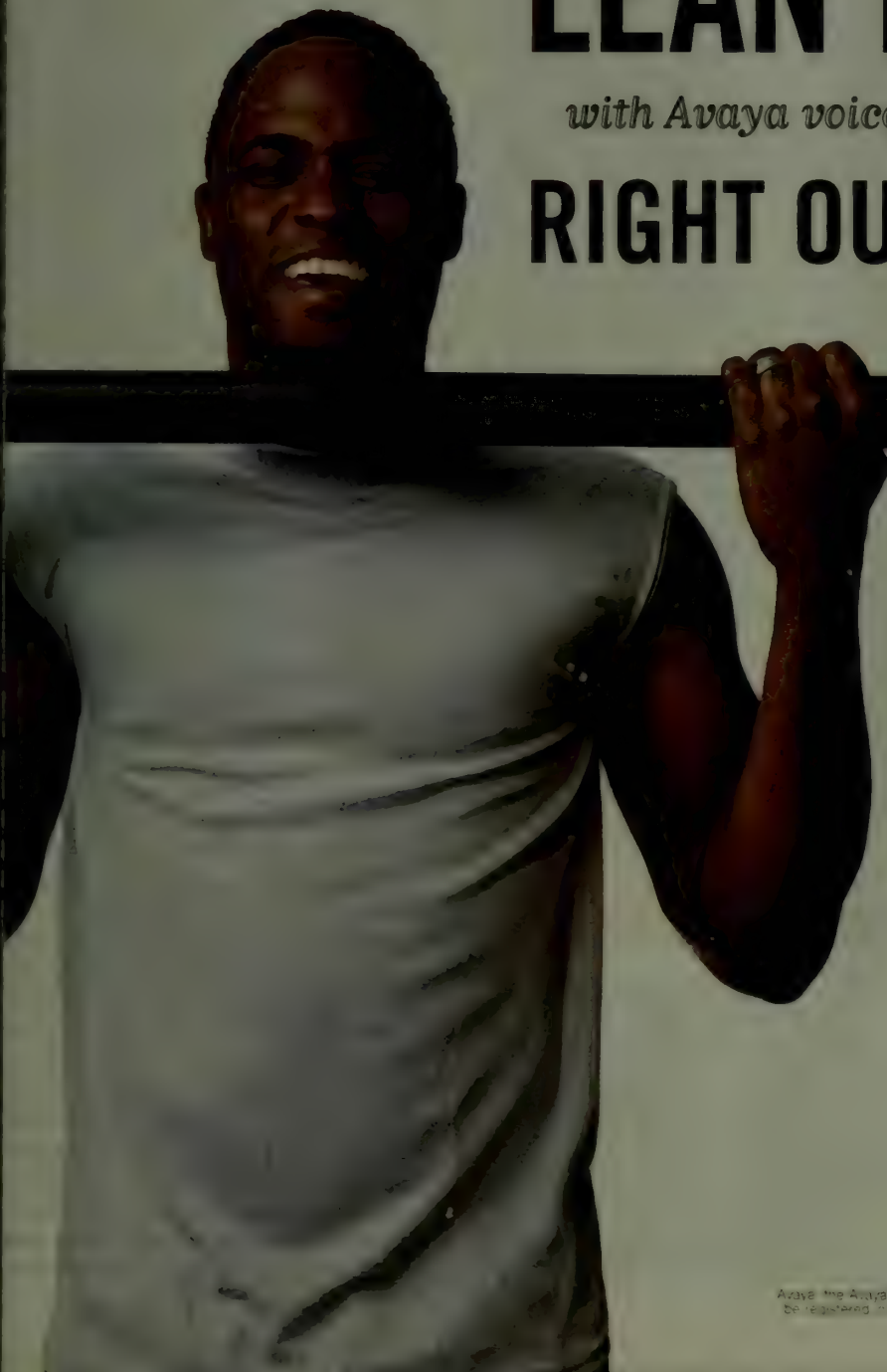
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SOFTWARE

Small, Yes—But With A Big Back Office

Subaru of New England Inc., an independent supplier of Subaru parts, used to track orders from dealers with pen, paper, and guesswork. It often sent its customers parts that they didn't need; in fact, returns averaged 80%. No longer. The Norwood (Mass.) company, with 45 employees, uses Web-based software to track what dealers need and when. Now returns are less than 1%.

Such Web-based software is transforming small-business functions from cash-flow management to marketing. The jobs are done electronically, often on the Web and typically for a monthly fee. "Small companies are getting, in essence, a virtual planning department," says Eric Hinkle, CEO of Atlanta's Servigistics Inc., whose software Subaru of New England uses.

Champions of Web-based software envisioned it as a way for big companies to decentralize, letting remote units use software at the home office. But the big companies were reluctant to let back-office functions operate outside their firewalls. And they wanted lots of customization. "Small companies are happy to forgo the bells and whistles," says Julie Giera, a research fellow at consultant Forrester Research Inc. "They're getting the back-office functions of an IBM—without paying \$250 million a year."

Small businesses often find that paying suppliers is a headache. So New York-based TradeCard Inc. provides Web-based software that, among other things, compares what's received against what was ordered, and releases payment if the



SIBLEY More effective media buying

two match. It enables Hi-Tec Sport USA, a hiking boot company in Modesto, Calif., with 70 employees, to pay suppliers on time and track boots for shipment from its factories in China.

Web-based software isn't the only new technology being embraced by small business. When Patricia C. Sibley started MediaSolutions, a media-buying company in Atlanta, 10 years ago, she needed two staffers per account. Now one staffer can handle four accounts. One key is a media-buying program called SmartPlus. Says Sibley: "What technology has done for us is unbelievable."

Small companies can rarely compete head to head with behemoths. But the latest generation of information technology is making the playing field far more level than it has ever been before. ■

—By Charles Haddad in Atlanta

economy until now, business investment is finally accelerating. That's good for small businesses that mainly sell to other businesses.

Business is far from booming, but at least there are signs of progress. "Even one was in a maintenance mode for the longest time," says Keith M. Parent, CEO of Court Square Data Group Inc., a Springfield (Mass.) information-technology consultancy. "I'm starting to see people loosen up on the purse strings." David Bland, president of Trivis Inc., a Birmingham (Ala.) company that advises nuclear plant operators on how to deal with the spent fuel rods, also sees a pickup in spending. "People are still cautious, but they can't wait forever," he says. "We had 60 to 90 days of pretty good orders. I believe the economy has turned."

SNAP, CRACKLE, POP

EVEN IN MANUFACTURING, some small companies are managing to grow. Wolverine Proctor & Schwartz Inc., a leading maker of ovens for dry cereals, was founded in 1930 and developed a process that puts the snap, crackle, and pop in Rice Krispies. But it was so heavily in debt by 2001 that it couldn't post standby letters of credit against customers' deposits on the ovens they were buying. That year, Parthenon Capital LLC, a Boston investment firm, took over and paid off its obligations. Since then, revenue has risen 20% and earnings have doubled.

In some ways, the resilience of small business during this recovery fits in with the trends of the past two decades. In the early 1980s, the output of companies with fewer than 500 employees was 4% less than the output of businesses larger than that, according to an analysis of Commerce Dept. and Internal Revenue Service data by Joel Popkin & Co., a Washington-based economic consulting firm. Since then, though, small business has rebounded and produces about 15% more than the big guys, according to the Popkin report, which was published in July by the Small Business Administration.

Advocates for small business, including the SBA, like to argue that the sector accounts for the vast majority of U.S. job growth. That's usually an overstatement—there are times when big businesses account for the lion's share of job growth. However, what small businesses do provide is a relatively stable employment base. They hold on to workers in hard times because they know they'll be hard to replace when good times return. What's more, small businesses are flexible

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Database tools devised for large marketing and advertising firms now help small companies target new customers.

AUTOMATED ACCOUNTING

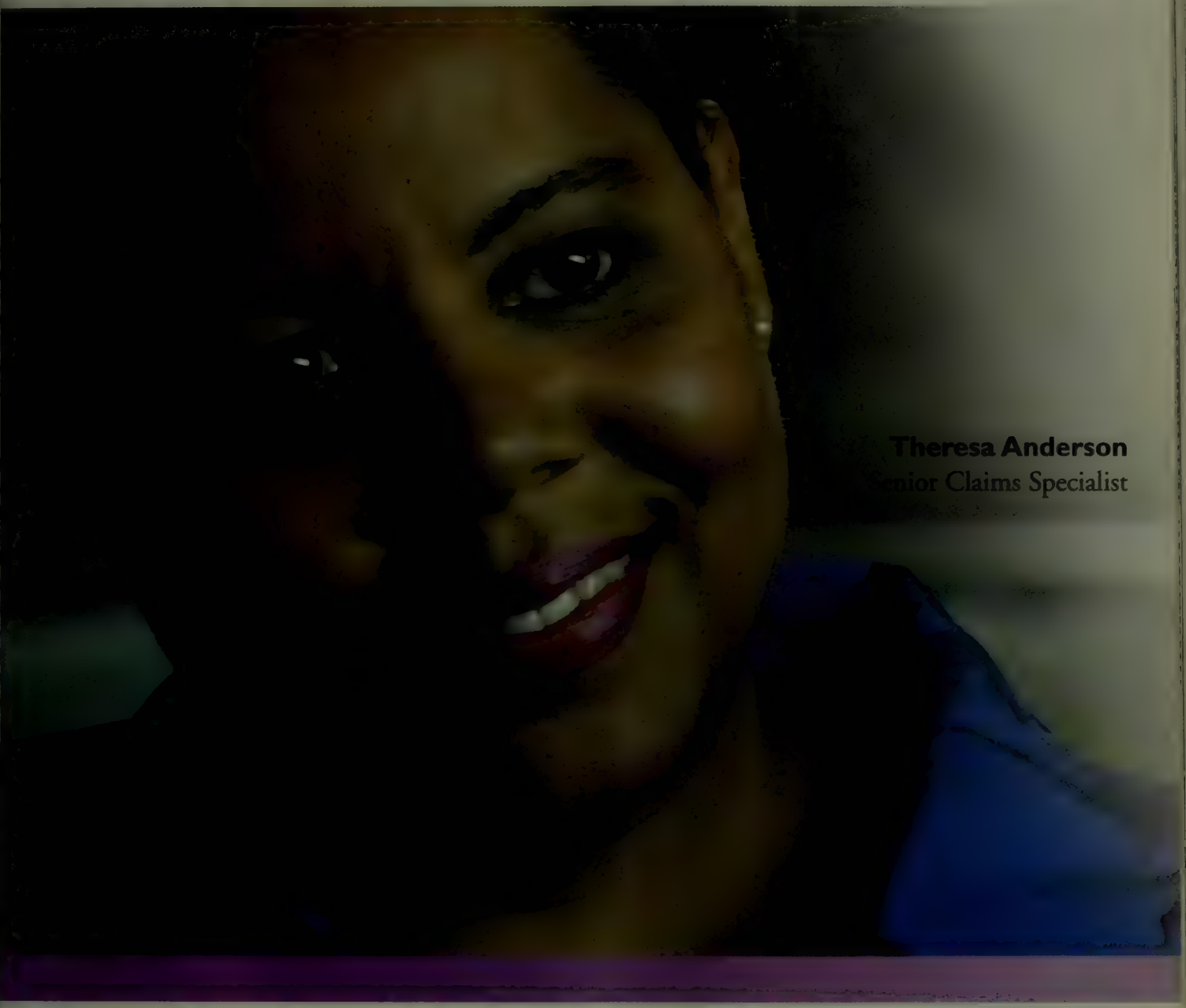
Simplified paperless accounting systems enable small businesses to order and pay for supplies online.

INVENTORY CONTROL

Low-cost Web-based inventory-control software cuts costs by tracking items down to the smallest screw.

Source: BusinessWeek

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and innovative. Small companies often initiate products and services that are later perfected by big companies, from the helicopter and air conditioning to the personal computer and the heart valve. "There's this romantic notion that we need lots of small business to generate jobs. What we need is a mix of small and large businesses," says Robert E. Litan, a senior fellow at the Brookings Institution and vice-president for research at Ewing Marion Kauffman Foundation in Kansas

City, Mo., which promotes entrepreneurship and education. Small businesses can't make it all by themselves. But they kept their heads above water during the hard times. And now they're doing more than their share to get the U.S. economy growing again. ■

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HEALTH CARE

Throwing a Line to Uninsured Workers

Yankee Fleet, a 50-person charter boat company out of Gloucester, Mass., had wanted to buy health insurance for its employees since the mid-1980s, when rising premiums forced it to drop coverage. But it was stopped by carrier requirements that at least 80% of eligible employees sign up. Yankee Fleet had too many who couldn't afford it, making the whole company ineligible.

Then in 2000, Yankee Fleet joined Massachusetts' Insurance Partnership program, which subsidizes the employee share of health insurance premiums for low-wage workers. Now, about 30% of Yankee Fleet's employees get a subsidy, and the company offers health insurance to everyone. "We would have lost some of our key people if we couldn't get the insurance," says CFO Tom Conley.

SMALL COMPANY, BIG PROBLEM

It's not just the charter fleets of Massachusetts. Across the country, heads of small businesses rank the cost and availability of health insurance as the biggest problem facing their businesses. No wonder—their deductibles are on average twice as high as those at big companies, and their costs are rising faster. Last year premiums at companies with fewer than 200 employees jumped an average of 16%, compared with 13% at big companies, according to the Henry J. Kaiser Family Foundation. Many small businesses simply give up: Of the roughly 44 million Americans without health insurance, half work for a small company or depend on someone who does, according to the Employee Benefit Research Institute.

Dozens of state and local governments are trying to help. The range of approaches is wide: California and New York City have

purchasing pools to make health insurance affordable for small businesses. Other places, such as San Diego, Oregon, and Rhode Island, have subsidies similar to the Massachusetts program. In a few Michigan counties, the government subsidizes both small companies and their employees.

Of course, when it comes to health insurance, good intentions aren't enough. One question is whether these programs can attract small businesses. The other is

program offers no subsidies, instead aiming to ease small companies' administrative burden. Employees can choose from 26 plans offered by five insurers, but the business owner writes just one premium check. Those with questions get an in-person consultation. The mayor's office has given \$3.8 million to HealthPass, but the program now covers 80% of its costs through fees. Executive Director Mitch Zaretsky says HealthPass will break even when about 18,000 people enroll—which he hopes will happen by the end of 2004. Since 1999, 1,600 businesses and 12,000 employees—62% of whom had no health insurance before—have signed up. HealthPass cut premiums 25% for law firm co-owners Justine and Gabriel Marous, by letting them buy just coverage they needed.

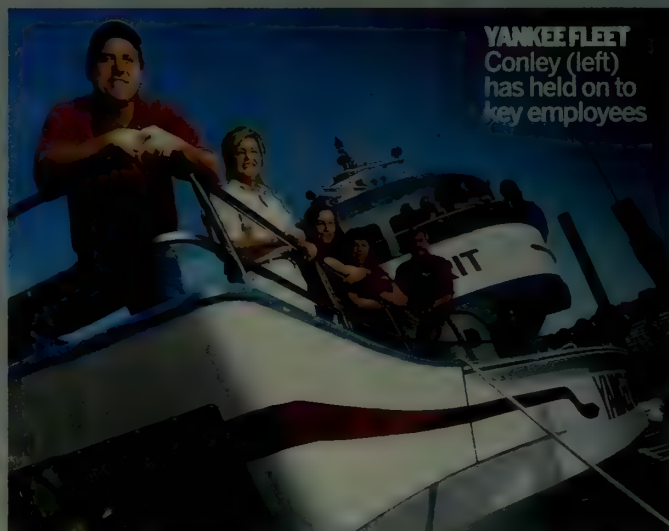
Another approach comes from Michigan's

Muskegon County Community Health Project, which subsidizes health-care costs for employees and employers at small companies with a median wage below \$11.50 an hour. In addition to using some Medicaid money, the organization contracted with doctors directly, convincing many to lower their rates. Their plan, Access Health, covers care only

within Muskegon county, but 97% of the county's health-care providers participate. After 2½ years, it covers 1,500 people at 400 companies.

Optimists say these initiatives could show the way for federal programs. "We'd argue to members of Congress that they ought to take a close look at the variety of models out there," says Vondie Moore Woodbury, director of the Muskegon County Community Health Project. Small businesses should do their research, too. They might be pleased by what they find. ■

—By Kimberly Weisul in New York



YANKEE FLEET
Conley (left)
has held on to
key employees

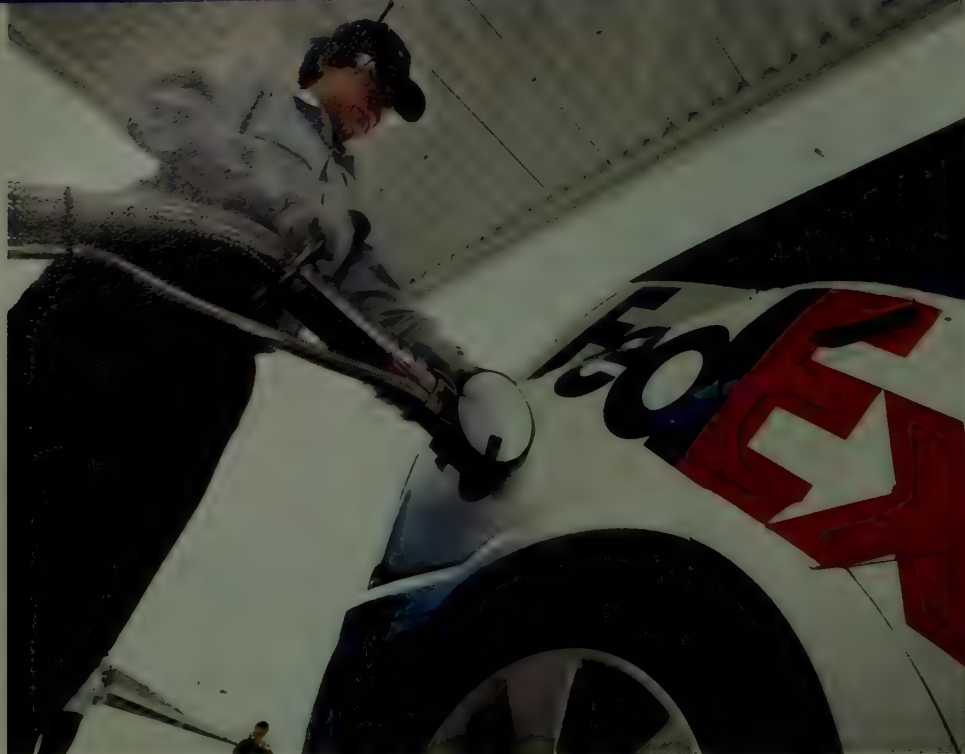
how to fund them when money is tight. At various times, for instance, Massachusetts' Insurance Partnership has scratched up money from federal matching Medicaid funds, the state budget, and tobacco settlement money. To qualify for the Massachusetts program, small companies must pay at least half their workers' health insurance premiums. Individual employees can't make more than twice the federal poverty guidelines, or \$36,800 for a family of four. The program has enrolled 4,500 businesses and 13,000 people since 1999.

By contrast, New York City's HealthPass

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Japan's Power Play

NEC, Toshiba, and Sony are developing ever-smaller fuel cells to replace batteries

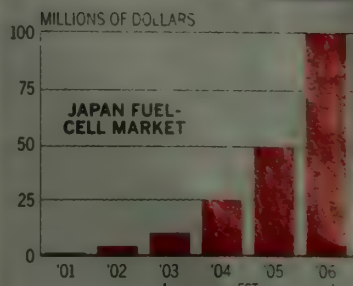
THE JAPANESE ARE A tough lot to please when it comes to gadgets. So when NEC Corp.'s stand at the WPC Expo computer trade show in mid-September started to draw crowds like Tokyo's Shinjuku Station at rush hour, it was clear something extraordinary was on display.

It turned out to be a fuel-cell-powered laptop. The 4½-lb. computer can go five hours before its cell needs to be refilled with methanol. That performance beats all but the hardest of laptops running on regular batteries. NEC plans to sell an even lighter fuel-cell machine late next year, and a year after that says it will release a model that can operate 40 hours on a single fill-up. Thanks to NEC's advances in nanotechnology,

"We're confident that fuel cells will become the main power source for mobile devices," says Yoshimi Kubo, the senior research manager overseeing the development of NEC's new laptop. "It'll be a very big and lucrative market."

Japan seems determined to dominate that business. NEC, Toshiba, Sony, and dozens of other Japanese companies are working feverishly to create ever-smaller cells to replace the rechargeable batteries in laptops, cameras, cell phones, and other gadgets—now a \$4.8 billion global

CHARGING UP



Data: Allied Business Intelligence

market. In 2005, Tokyo Gas Co. plans to start outfitting thousands of homes with affordable fuel-cell units that generate hot water and energy. Toyota Motor Corp. and Honda Motor Co. already have nearly two dozen fuel-cell-powered cars on the streets, and there are nine filling stations in three Japanese cities

ROAD WARRIOR
FedEx makes Tokyo deliveries in a fuel-cell-powered vehicle

where they tank up. Even General Motors is helping provide FedEx Japan in July with

its HydroGen3 car to make deliveries in Tokyo. "Japan is a key area for development and positioning fuel-cell cars for commercialization," says Raymond Grigg, chairman and CEO of GM Japan Ltd.

Fuel-cell advocates say the devices are the future of energy. They produce electricity through a chemical reaction that combines oxygen with hydrogen. The oxygen comes from the air, and the hydrogen can be produced in a cell from methanol or natural gas. Or, as is the case in most fuel-cell-powered vehicles, pure hydrogen can be pumped into the cell, and only water comes out of the tailpipe. The downside is that hydrogen is expensive to produce and difficult to store.

STICKER SHOCK AHEAD

MANY INITIATIVES ARE also under way in Europe and North America. Motorola Inc. is testing a methanol cell for phones and handhelds. And others are working on devices for homes and cars. But Japan stands out for its variety of commercial applications. In 10 years, the global market for fuel cells could hit \$18.6 billion, and Japan will account for as much as a third, that, according to market researcher Allied Business Intelligence Inc. "Japan has clear advantages," says Atakan Ozbek, Allied's director of energy research. The big money—if the technology matures enough—will almost certainly be in cars and buses. The Japanese government wants to have 50,000 such vehicles on the road by 2010 and 5 million a decade later.

Plenty of hurdles remain—not least of which is sticker shock. The cars cost nearly \$1 million to build. Prices will come down if engineers can replace the expensive platinum used in today's cells with less costly alternatives. But there's another large obstacle: building enough filling stations to supply hydrogen for all those cars.

Fuel cells are just what a resource-poor country like Japan needs—a clean, efficient source of energy that doesn't require huge imports. So this year, the government has set aside \$280 million to fund fuel-cell projects, up 40% over 2002. Ultimately, though, Japanese companies will have to wean themselves from state support and make fuel-cell production profitable. If they can, there will be a double dividend: a new stream of profit for Japan Inc. and cleaner air over the nation's cities. ■

—By Irene M. Kunii in Tokyo



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Memory	1-5MB	32-96MB	48-304MB	64-416MB	80-416MB	
Paper capacity	200 sheets	250 sheets	350-850 sheets	600-2,600 sheets	600-2,600 sheets	
Monthly duty cycle	20,000	10,000	50,000	150,000	200,000	
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BY CATHERINE ARNST

The latest advances against cancer were presented Sept. 21-25 at the European Cancer Conference in Copenhagen, where updates were presented on clinical trials and basic research. Here are several of the noteworthy findings.

INNOVATIONS

Patterns In the genes

»» In the first study to show such a link, researchers found that women whose children develop cancerous tumors by the age of 5 have double the risk of developing breast cancer in the first 10 years after the birth. A research team led by Dr. Dong Pang at Britain's **Royal Manchester Children's Hospital** said such mothers are at even higher risk if the child is a boy. The link only showed up for children with solid tumors, not those with blood diseases such as leukemia. Pang said abnormal hormone levels in



the mother during pregnancy and a disruption of tumor suppressor genes could be the cause.

»» In a study of 41 breast cancer patients treated with radiotherapy, Danish researchers have identified specific variations in four genes that correlate with different types of radiation damage. Dr. Nicolaj Andreassen of **Aarhus University Hospital** said the discovery could help predict how patients' cancers might respond to the treatments.

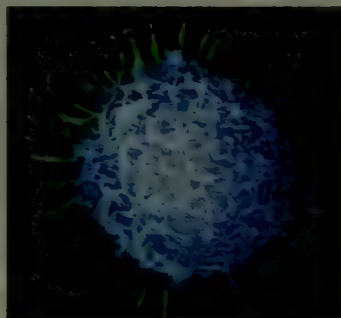
HORMONES

WHY DID PROSTATE CANCER DEATH RATES FALL?

THE OVERALL U.S. cancer death rate has barely budged in the past two decades, but there is a shining exception: prostate cancer. After slowly rising during the 1970s and '80s, prostate cancer deaths fell by one-third in the '90s for men age 50 to 74.

A new analysis of existing clinical-trial data attributes part of the improving outlook to early detection and prompt surgery, but mostly credits follow-up hormone therapy. "Hormonal treatment as a whole works ridiculously well," said Sir Richard Peto, professor of medical statistics at **Oxford University**.

Prostate cancer is usually treated with surgery or radiation, but a few cancer



cells may remain and cause an often-fatal recurrence. Since the mid-'80s, oncologists have increasingly followed up with either surgical removal of the testes, or with newer anti-hormone drugs. Peto said that 74% of men who received hormone therapy were still alive 10 years later, compared with 62% of those who did not.

VACCINES

HARNESSING HEAT SHOCK PROTEINS

PROMISING EARLY results were presented at the conference for a novel cancer vaccine that makes use of so-called heat shock proteins. These proteins help repair damage to the cell caused by stress—an unwanted survival mechanism in cancer cells.

Antigenics' Oncophage vaccine is created from heat shock proteins taken from a cancer victim's own tumor. When injected, the vaccine is meant to prompt the immune system to attack cancer cells

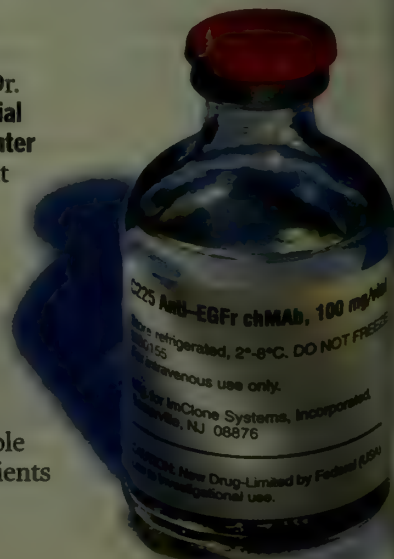
containing those same proteins. In a Phase 1 trial, the vaccine was given shortly after surgery to 10 patients with pancreatic cancer. This is a particularly deadly disease, with an average survival time following surgery of 14.5 months. Dr. Robert G. Maki of **Memorial Sloan-Kettering Cancer Center** in New York reported that two of the 10 patients were alive and disease-free after more than two years, and one was still alive and disease-free after five years. He cautioned that larger studies are needed to learn if it would be possible to treat all pancreatic patients with the vaccine.

BIOTECH

DRUGS THAT ARE GOOD AT MULTITASKING

STUDIES OF A NEW generation of targeted therapies dominated the 2003 European Cancer Conference. These drugs home in on a particular cancer-enabling mechanism found in a variety of different tumors. Thus **Erbixut**, developed by **ImClone Systems**, has primarily been tested against colon cancer, but a European study indicates it may also be effective against lung cancer.

A team led by Dr. Rafael Rosell of Hospital Germans Trias i Pujol in Barcelona tested 85 lung cancer patients, all with tumors that expressed high levels of a growth-inducing protein blocked by **Erbixut**. Over 15 weeks, 43 of the patients received chemotherapy, while 42 were given chemo plus a weekly injection of **Erbixut**. Rosell reported that the disease was reduced or stabilized in 58.4% of the patients receiving **Erbixut**, compared with 29.7% of those on chemo alone. "This combination therapy looks very promising" as an initial treatment, he said.



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MAKING HIS MARK
Immelt's initiative
is a cultural shift
from the GE of old

Will Jeff Immelt's New Push Pay Off for GE?

The giant is gambling that helping customers beyond the call of duty will reboot growth. **BY DIANE BRADY**

NOT LONG AGO, KATHERINE A. Findlay of Southwest Airlines Inc. noticed a change in the hard-charging folks from General Electric Co. Along with aggressively selling and servicing her jet engines, they suddenly wanted to help the overall business. "They started asking:

"How can we help you be more efficient and cost-effective?" says Findlay, who handles finance and contracts in Southwest's maintenance unit.

But when GE offered to send over a "black-belt" specialist from its Six Sigma quality program to work for several months at no cost on a problem that had nothing to do with GE products, Southwest balked. Who wants to share private

information about one supplier with another? And few at the airline had time for the rigid, almost religious dogma associated with Six Sigma. Much as they liked GE, that kind of thing didn't fit Southwest's swashbuckling culture. "We try to have little more comic relief," says Findlay, who boasts that she doesn't own a blue suit.

Even so, in mid-2000, Southwest executives relented and allowed Lori L. Kre-

GE Aircraft Engines to come in to help solve problems with a component made by another company. While the problem didn't compromise safety, it was a nagging headache. Although Kress was taken aback by Southwest's balloons in the cockpit, executives in shorts, and a welcome aboard hug from Chief Operating Officer James C. Wimberly, she helped figure out and fix the problem. The part went from having 10 failures over the previous 18 months to none—and Kress helped introduce Six Sigma concepts. "Lori even taught us a sandwich or two," says Findlay, whose airline has since let dozens of GE folks work on projects, including financial analysis and invoice flows.

While Southwest execs are still more likely to chat about their weekends than bull diagrams, they claim to have a deep appreciation for GE. Says Kress, a pioneer in what ballooned to 10,000 similar projects last year: "The more successful our customers are, the more successful we will be."

KING UP THE BEAST

IT'S CLEARLY THE BET of Chairman and CEO Jeffrey R. Immelt. Since he assumed GE's top job two years ago, Immelt has tried to turn the \$132 billion giant into a truly customer-focused organization in part by sharing its best practices. The revolution dubbed "At the Customer, For the Customer"—or ACFC, in GE lingo—isn't just fuzzy feel-good rhetoric. Immelt's push is changing how GE operates, including how its different units interact and how its profit-driven salespeople are measured. These days, everyone must live up to the line exactly what they've sold for customers lately. Think of how Chairman John F. "Jack" Welch shook up

the ranks with initiatives such as Six Sigma or Work-Out, which got employees from all levels involved in decisions. While Immelt himself won't quantify the cost or payoff of his push so far, he points to thousands of projects worldwide and says that up to 40% of clients already want to be on board. As he puts it: "There is not one person in GE who is not going to know how to do this."

The test is what all this love is going to do for the company. With GE struggling to grow—its earnings fell 14% in the second quarter of 2003, to \$3.8 billion, on flat sales—Immelt has to do something to shake up the beast. The logic is simple: In an age when products can fast become commodities and service contracts go to the lowest bidder, companies are desperate to differentiate themselves and add more value in serving their customers. So why not make yourself indispensable by bringing your best people, resources, and skills to bear on customers' problems? As analyst Nicole M. Parent of Banc of America Securities argues: "Most companies don't have the culture, the resources, or the processes to offer this kind of thing."

True, but GE is operating in some slow-growth industries where it may be tough to grab more market share. And it's hardly the only company reaching out to customers. Rival United Technologies Corp. says it, too, is trying to share its best practices with customers. Meanwhile, Cardinal Health Inc. credits its customer focus with pushing the company to move beyond

THE STATS

40%

Share of customers who want GE's quality and productivity initiatives in their workplace

Data: General Electric Co.

drug distribution into recordkeeping, managing drug dispensing, and even customizing medical-supply kits for surgeons. "Our goal is to be an essential partner with our customers and help them solve their most pressing issues," says Chairman and CEO Robert D. Walter. Cardinal's annual earnings have grown in the past 10 years to \$2 billion from \$47 million.

Companies from IBM to beleaguered Xerox Corp. have also tried to turn

their expertise into new services that enhance their mojo in the market. Even Hewlett-Packard Co. is hawking its prowess as a consolidator and rabid cost-cutter based on its two-year experience in merging with Compaq.

Still, few companies have a history of driving management initiatives into the bones of every employee the way GE does. And few are as copied when those initiatives pay off. That doesn't mean persuading GE troops to become customer advocates has been easy. For one thing, these are people whose bonuses and careers have been tied to how much they sell, not how much they help their fellow man.

INTERNAL RESISTANCE

IMMELT SAYS THAT improving customer productivity is now a critical part of performance evaluations. But even he concedes that there has been some resistance to offering any help that doesn't immediately boost GE's bottom line. "The guys in our financial-services salesforce kind of said: 'You've got to be [kidding] me. Six Sigma?'" he recalls. "It's taken me a couple of years to say: 'This is your day job, and it can help you grow faster and it can make you more money.'"

Making money, after all, is what this is all about. The bulk of GE's initiatives focus on companies that matter and projects that can be directly measured in terms of fewer breakdowns or higher customer profits. Shareholders such as Michael Holland of New York investment firm Holland & Co. aren't worried about the investment of GE's time and people. "There are some incredibly useful things that Jack left behind that can be packaged to help customers," he says. "And I bet it's all priced in."

Tapping into the knowledge base of GE is a negotiating tool or benefit of doing business, not an end in itself. Bringing customers to GE's research and development

The GE Way

Immelt hopes to improve customers' fortunes—and win their loyalty—by transferring to them some key GE concepts:

BLACK BELTS FOR ALL!

Experts share secrets about productivity-enhancing innovations such as the massive Six Sigma quality initiative, which has become a religion within GE.

RAIN TRUST

Customers can tap into a ton of data, such as market information and basic research, generated by GE units.

CULTURE FOR SALE

GE offers training in its trademark management techniques—everything from empowering the little guy through "Work-Out" to creating a "learning culture." And don't forget to boot out that bottom 10%.

GOING GLOBAL

GE is sharing its global expertise, including free chitchats about China or connections in outsourcing service to India.

The Corporation Strategies



centers or famed training facilities in Crotonville, for example, is meant to improve productivity, not provide free field trips. "We have to make sure they understand it has value to them," says J. Jeffrey Schaper, GE's chief commercial officer. "We are not the world's most philanthropic company."

Nor, lately, has it been the world's most profitable. Despite a leadership position in most of its businesses, GE didn't crack the double-digit earnings-growth bar last year, growing 7%, to \$15.1 billion, while revenues inched up just 5%, to \$131.7 billion. This year has been worse. Raising prices on products and services simply isn't an option for many companies. Customers are too sophisticated, and competition is too great. The answer, says Adrian Slywotzky of Mercer Management Consulting Inc., is to grab extra share in slow-growth businesses, such as jet engines, plastics, or power turbines, by enhancing one's value to customers. "It's not enough to be customer-centric," says Slywotzky. "You need to become sophisticated about your customers' ac-

tivities and internal processes."

Few CEOs understand that like Immelt. The former Dartmouth College football lineman and fraternity president grew up in sales, having jumped from Procter & Gamble Co. to GE's marketing department after graduating from Harvard Business School. He tested those customer skills through stints at GE Plastics during a price collapse, GE Appliances amid a massive product recall, and, most notably, in GE Medical Systems, where he first pushed the notion of tapping the corporation's resources to give customers more bang for their buck. During his tenure from 1997 to 2000, Immelt increased the service portion of the medical business from 25% to 42% of revenues and increased profits threefold. That helped him develop a reputation as someone who could think big and deliver the numbers—skills that were instrumental in the board's decision to name him CEO in late 1999.

Not surprisingly, GE Medical has been a showcase for the customer-centric approach. Take University Community Health

MEET AND GREET

Immelt surprises customers with his level of involvement

System in Tampa, which had long bought medical equipment from GE. When the organization decided to build state-of-the-art heart hospital and research center

last year, GE joined in the bidding with some extra enticements. Not only did GE offer the usual equipment and service, they helped build a system around technology GE is developing that isn't even on the market yet. Hospital execs also got advice on leadership development, workplace design, and coordination with other units of GE to help build the facility.

STRATEGIC PARTNERSHIP

THE PAYOFF FOR GE? It will supply all the new hospital's clinical information technology and over 80% of its diagnostic and imaging gear. The contract will also run up to seven years, vs. the usual one to five years for normal pacts. Other bidders didn't come close in trying to forge a strategic partnership, says COO Brigette Shaw, adding: "We don't have the intellectual capital and resources to make this happen on our own."

It wasn't so long ago that GE was legendary for a different kind of ethic. A University of Michigan professor and sometime GE consultant Noel Tichy noted that in the mid-'80s, GE was known for being "ass to the customer, face to the

THE STATS

80%

Share of GE diagnostic and imaging equipment in Tampa's new heart-care hospital

Data: General Electric Co.



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CEO." While Welch himself was a top salesman, having essentially created a market in what seemed to be the dying plastics industry when he led that GE unit, the company seemed to focus as much on itself as it did on customers during his tenure. First was the brutal restructuring of the 1980s, in which GE's workforce was almost halved from its original 402,000. Then came such initiatives as Work-Out, Change Acceleration Process for managing change, and Six Sigma. While all ultimately had an impact on customers, they dealt mainly with the way GE got things done. The company became renowned as a management laboratory and a money-making machine.

In some ways, GE's size and reputation present a challenge to the success of Immelt's push. Nobody is more infatuated with what GE has to offer than the folks who work there—and that can breed a bit of smugness. It's hard to really listen to the customer when you're the one with the world-famous expertise, and you're used to working on your own timetable. Jim

Current, one of about 200 young executives picked each year for the new commercial-leadership program, had to tell his bosses at GE to back off on closing one project because the customer didn't feel it was finished. "I had to push back at GE," says Current, sounding a little surprised by his ownchutzpah. Chief Marketing Officer Beth Comstock, who is running the leadership program as well as a more integrated marketing effort, notes that the challenge is to "customerize GE, not GE-ize our customer."

After all, some of those customers already see more than enough of GE. If you have a quality-control program, for example, who needs a bunch of GE black belts running around? Plus, no customer wants to get in bed with just one supplier. John M. Samuels has felt the full brunt of GE's new

WON OVER At first, Southwest Airlines' Findlay resisted GE's offer of in-depth help

customer push senior vice-president for operations, planning, and supply at Norfolk Southern Corp. Samuels

appreciates GE's valuable training and was taken aback by time that was devoted to the railroad. Immelt himself. But while GE's help via programs such as Six Sigma has improved his profitability, Samuels says, the real question remains whether GE can "maintain a quality product at a competitive price. What's more, he adds: "GE would definitely love to be our only supplier, and that is going to happen."

HARD-PRESSED CUSTOMERS

MEANWHILE, IT CAN BE tough for employees to generate enthusiasm helping customers when their own house is burning. Henry A. "Harry" Reeves, for example, is president of Plastics Americas at a time when a growing portion of plastics manufacturing is shifting to spots such as China. "My core processing customers are essentially dying," he says. For his people, being customer-centric can mean helping his own customers relocate to another part of the world where, he hopes, other parts of GE can get the business. So his hard-pressed customers aren't as receptive to GE's help as they were in a previous job at GE Mortgage Insurance. They're just trying to survive.

If Immelt's baby lives up to its hype, the push could lead to less business in some cases. Take GE Fleet Service, which brought some of its best practices to a large utility customer and found it had hundreds of excess trucks on the road. GE whittled the number from 9,000 to 8,000—saving millions of dollars, some of which would have gone to GE. "We used to try to get as many cars and trucks out there as possible," says unit CEO Kathy V. Marinello. "But the focus

now is on how do we make them succeed."

Good question. In GE, of course, the large question is whether pouring a lot more resources into customers will pay off for GE's bottom line. ■

THE STATS

-14%

GE's second-quarter earnings drop—one reason it needs to add value for customers

Data: General Electric Co.

BusinessWeek online

For an interview with GE CEO Jeff Immelt, go to www.businessweek.com/magazine/extra.htm

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Keep the Customer Satisfied

That's the lesson of our midyear update of the Top 50 corporate performers

THE TEST FOR SMART management isn't that it doesn't make mistakes. It's whether it knows how to fix them. In 2001, consumer-electronics giant Best Buy Co. paid \$685 million for the Musicland chain. This June, after watching more and more consumers defect to free downloaded music, Best Buy threw in the towel. Conceding that the synergies it saw between music stores and its core business of selling audio systems, DVD players, and TVs had not materialized, Best Buy sold Musicland to a private investment firm for no net cash.

"RETAIL IS DETAIL"

A DISASTER? NOT BY a long shot. Now free to focus on its core retail business, Best Buy kept right on winning market share from troubled rivals like Circuit City Stores Inc. by keeping customers happy. "The cliché is 'retail is detail,' and Best Buy does thousands of things right," says Jefferies & Co. analyst Don Trott. Best Buy, for instance, was one of the first big electronics retailers to devote significant floor space to traffic-driving CDs and electronic-game software. It generated 75% higher operating income in the quarter ended Aug. 30, compared with a year earlier, and strong 5% gains in same-store sales so far this year. Investors were rewarded with a total return of 68.3% from Mar. 19 to Sept. 12. That was the best of any company on our BusinessWeek 50 list of top performers over the past six months.



(Best Buy was added to the BW50 in April, after Pharmacia Corp. was acquired by Pfizer Corp.)

That kind of strong consumer focus was evident for many of the top BW50 companies at the midyear mark. Electronic Arts Inc. returned 52.6% over six months, cranking out video games. Analysts say that its strategy of licensing marquee names, such as football pundit John Madden and Harry Potter, could boost fourth-quarter earnings to almost as much as it earned in all of fiscal 2002. Another BW50 company, Pulte Homes, generated a 31.3% shareholder return by riding the housing boom, especially homes geared to older but still active buyers. In fact, the consumer discretionary sector returned 22.6%, making it the third-strongest category—behind information technology and materials—in the Standard & Poor's 500-stock index.

The S&P 500 is the pool from which we pluck the BW50 each spring. Companies are ranked on growth of sales and earnings, and shareholder returns over one and three years, and year-to-year growth in net profit margins and return on equi-

ty. The result is essentially a growth list. But because the three-year period of time took in the dot-com downturn, 2003 BW50 was light on technology companies. That explains why the BW50 group underperformed indexes that better captured this year's runup in the stocks: The BW50 returned only 12.5% over the six months, vs. 17.5% for the S&P 500 and 33% for the Nasdaq.

COMATOSE BARBIE

IT DIDN'T HELP that some of the companies that replaced the tech stars fell into their own holes. Bringing up the rear in terms of stock returns was Mattel Inc., whose shareholders suffered a 10% loss. The toymaker's turnaround appears to have stalled. CEO Robert A. Eckstein launched new toys like the hip-hop Flavas dolls. But that can't make up for the fact that little girls just don't love Mattel's core Barbie like they used to. Says Brean Murray Research analyst Margaret Whitfield: "Barbie remains comatose."

Drugmaker Fortis Labs fell back from a high, returning -5.4%. And insurer Aflac Inc. and its trademark duck waddled in with a -4.7% turn. While Aflac's Japanese business is strong,

investors worry about flagging U.S. sales growth. In fact, the company says it expects no growth in domestic new-premium income in the fourth quarter. To help turn things around, Aflac named a new U.S. head of sales.

The BW50 was created to identify growth companies that are more than a flash in the pan. That methodology knocked some companies off the list that are now flying high on Wall Street. The rest of the year will prove whether they will sustain that pace—or whether the BW50 can catch up. ■

—By Dean Foust in Atlanta, with An Tsao in New York, Christopher Palmeri in Los Angeles, and Brian Grow in Chicago



Winners and Losers

BW50 returns*
climbed 12.5%, vs.
a 17.5% rise in
the S&P 500

*Change in price per share plus reinvested dividends, Mar. 19 to Sept. 12.
Data: Standard & Poor's Compustat

THE BEST

■ Best Buy	68.3%
■ Electronic Arts	52.6
■ General Dynamics	45.5
■ McKesson	37.7
■ Pulte Homes	31.3

THE WORST

■ Mattel	-10.0%
■ Johnson & Johnson	-9.1
■ Forest Laboratories	-5.4
■ Aflac	-4.7
■ Freddie Mac	-1.1

In every field of endeavor,
there are the weak,
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There are the faint of heart,
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The rise and fall of the high-tech investment banker who was an architect of Silicon Valley's financial culture **BY LINDA HIMELSTEIN**

Nobody knew it at the time, but the apex of the Internet rocket ride came on the morning of Dec. 9, 1999. Executives of computer maker VA Linux Systems Inc. gathered at 6 a.m. in the trading offices of Credit Suisse First Boston on the 17th floor of a San Francisco skyscraper for the company's initial public offering. Among those assembled were Larry M. Augustin, the chief executive, and his friend Linus Torvalds, the inventor of the Linux operating system, who was dressed in his customary T-shirt and sandals. Their three toddlers

scampered around underfoot while the adults watched in stunned silence as the stock price jumped from 30 a share to more than 200 within minutes. Augustin nudged Torvalds and whispered: "Did you ever think we'd be here?" At the end of trading, the company's shares were worth 239.25 apiece, up 697.5%, making it the best-ever first-day IPO performance.

The person they had to thank for this heady experience was Frank Quattrone, then head of CSFB's technology investment banking business. During more than two decades in Silicon Valley, the working-class kid from South Philadelphia had harnessed the forces of capital and innovation to create a money machine that showered the Valley with fabulous fortunes and helped drive productivity growth in the U.S. economy. Think of almost any household name in technology, from Amazon.com Inc. to Cisco Systems Inc., and Quattrone's fingerprints were on it—whether he helped the company raise venture capital, took it public, or advised its CEO on strategy.

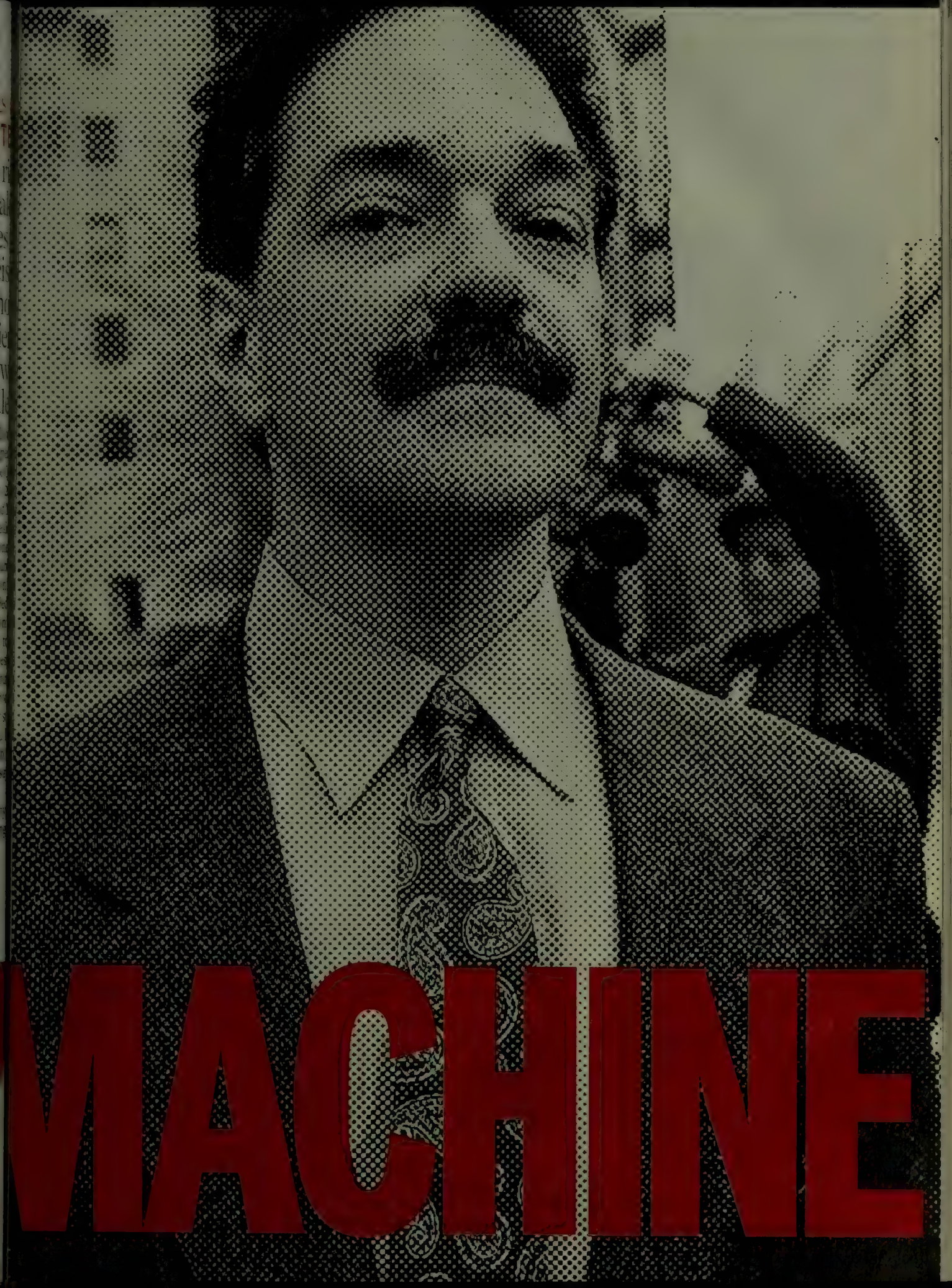
Quattrone not only stood at the intersection of power and wealth in the high-tech economy but was also one of its chief architects. He put the deals together, controlled who got in, and helped hand out the bonanzas. He was both a powerbroker and a rainmaker—a highly lucrative combination. Over the years, he

led hundreds of IPOs and other financings, raising \$65 billion for tech companies. But it was the tech stock boom that pumped his image up to near-mythic proportions. The ultracompetitive Quattrone and his team led 138 high-tech IPOs from 1998 to 2000, nearly as many as the next two—Goldman Sachs & Co. and Morgan Stanley—combined, according to market researcher Dealogic.

Today, only the lawyers are getting rich. Frank Quattrone, pale and puffy-eyed, occupies a chair at the defendant's table in U.S. District Court in lower Manhattan, where his trial on federal obstruction-of-justice charges began on Sept. 29. Federal authorities charge that he interfered with an investigation of improper allocation of IPO shares by sending an e-mail to employees on Dec. 5, 2000, urging them to purge unnecessary documents. He insists this was an innocent, routine reminder of company procedures. To drive home this point, Quattrone expected to take the stand in his own defense. It's a risky strategy. But Quattrone, whose powers of persuasion helped lead scores of deals, is betting that the same personal touch will swing the jury to his side. If he's convicted, legal experts say he could serve one or two years in jail.

Meanwhile, Quattrone faces a much broader inquest by the National Association of Securities Dealers into a whole range

INSIDE FRANK QUATTRONE'S MONEY



alleged rules violations, including making improper IPO share allocations and offering potential clients favorable analysts' coverage—charges he also denies. The NASD investigation was triggered by a tip about stock allocations that surfaced the day of Quattrone's triumphant VA Linux IPO. Roger B. Sherman, the NASD's senior vice-president for enforcement, testified at Quattrone's trial. By the time this process is over, much of Quattrone's professional life will have been laid bare—and thoroughly picked over.

It makes for a remarkable and sobering tale. In a two-month

investigation, *BusinessWeek* delved into Quattrone's financial empire, turning up details on his web of interwoven deals that underpinned the Internet economy—and the greed that fueled them. Take Quattrone's pay package. *BusinessWeek* learned how Quattrone used his clout and connections to

PEBBLE BEACH

Quattrone (right) and friends



HOW THE MACHINE WORKED

Frank Quattrone built a powerful machine for enriching himself, his associates, and his friends in the tech biz. Here's how he put himself at the center of Silicon Valley capitalism:



VENTURE CAPITALISTS

Quattrone personally invested in several venture capital firms, including Redpoint Ventures. The relationships gave him rich returns and detailed info on hot tech upstarts in the VCs' portfolios.



INVESTING IN STARTUPS

Quattrone and his firm took stakes in young tech companies such as PC maker eMachines and software maker Interwoven. The ties helped his firm win investment banking business, topping all others in 1999.



SCHMOOZING

Quattrone spirited high-tech leaders away on weekend outings, skiing in Utah's Deer Valley and golfing at Pebble Beach. One time, legendary golfer Gary Player hobnobbed with the guests. These friendships would pay off royally.



THE SOFT SELL

Quattrone was the master of marketing gimmicks. He pitched Amazon.com by binding his presentation into a book, and used a mule with a bottle of wine around its neck to sway Intraware's CEO.



CREDIT SUISSE FIRST BOSTON

Quattrone's authority reached beyond investment bankers, to analysts and some brokers. The NASD charges that he pressed analysts for upbeat reports on current and potential clients.



FRIENDS OF FRANK

CSFB's tech group doled out shares in hot upcoming IPOs to execs at other tech companies, a practice called "spinning." They repaid this generosity with banking business, alleges The NASD, which says spinning violates its gift rules.

a personal fortune. Quattrone's group reaped at least one-third of all the revenues they brought in above an arrangement. In 1999 alone, \$600 million poured into Quattrone's outpost, giving select participants in his group an estimated take of nearly \$150 million. Next year, the team's revenues jumped to \$1.4 billion, says an ex-CSFBer, landing them an even fatter payday. Quattrone alone pocketed \$200 million between 1998 and 2000, according to the NASD. Typically, at that time, top managing directors in investment banking took in \$1 million to \$10 million, according to estimates from Wall Street compensation tracker McLagan Partners Inc.

Interviews with more than three dozen Quattrone colleagues, business associates and friends reveal how he pieced together his empire. With the blessing of his seniors, he supervised the managers of not just investment bankers but also stock analysts and brokers. He also had budgetary control of his group—power enjoyed by virtually no other managers at CSFB. "The deal was almost like a joint venture, totally independent," says William Burnham, a former analyst who worked with Quattrone at CSFB.

That independence handed Quattrone more power and control than anyone else in tech banking. And he used it. His gifts of IPO shares to potential clients, which Quattrone's defenders say were legal, were good for business. But they also drove a wedge between the interests of individuals and their companies. And the grand paychecks for his team made it possible for CSFB to attract top producers even though critics say they rewarded bankers for the sheer number of deals, regardless of quality.

TACTICS ON TRIAL

WHILE IT'S QUATTRONE who is facing justice in Manhattan, a wide swath of Silicon Valley stands trial as well. Quattrone's banking tactics, many of which he pioneered, were adopted by other banks, ultimately becoming business-as-usual in the tech industry. This snowball effect helped create the market mania of the late 1990s and the resulting crash of NASDAQ stocks that cost investors more than \$5 trillion. If Quattrone is found guilty, the high-tech capital of the world is



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cleaner environment,
but I can't imagine
me without my car."

▲ Steph Willen/Independent Film Producer

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»» “Silicon Valley has to grow up. We can no longer think we’re this cute little outlaw place where we make our own rules,” says Intuit’s chairman

face increased pressure to overhaul its tight-knit culture.

Even in the face of the market collapse, scandals, and greater regulatory scrutiny, Silicon Valley today clings to the system that made Quattrone the most powerful high-tech financier ever. It’s one that locks together the interests of venture capitalists, bankers, lawyers, and entrepreneurs, much like Japan’s *keiretsu*. This sharing of information and advice often improves the performance of companies and hastens innovations to market. Yet the system creates conflicts of interest. Even now, lawyers continue to take equity and sit on the boards of client companies. Banks still invest in startups they take public. And tech executives still get rich off the money they sink into their venture backer’s funds.

A whiff of reform is in the air. “Silicon Valley has to grow up. We can no longer think we’re this cute little outlaw place where we make our own rules,” says William V. Campbell, chairman of software maker Intuit Inc. and adviser to startups. But in the offices and cozy lunch spots along U.S. highway 101, there’s also an impulse to let bygones be bygones, and to let Quattrone off the hook, too.

Quattrone can still count on an army of friends and former business associates to come to his defense. They contend he’s taking the fall for an ambiguous regulatory system that failed to restrain behavior that became commonplace as markets and in-

vestors stampeded out of control. His supporters include veteran venture capitalist C. Richard Kramlich, legendary tech investment banker Sanford R. Robertson, and entrepreneur James Clark, a co-founder of Netscape Communications Corp., which Quattrone took public. “The whole thing is a witch hunt,” says Clark. “Frank has been caught in a squeeze between people who make a mark by prosecuting people and the momentum of the times.”

What drove Quattrone? He declined to comment for this story. But interviews with those who know him paint a picture of a man who started off with a noble mission: to help build Silicon Valley into an economic powerhouse. But when the markets crested so frothily, Quattrone rode the wave faster and higher than anybody else. He became less tied to the details of the deal—and more focused on landing the deal. He was swept along by a confluence of driving ambition, the potential for untold riches, and the willingness of investors to devour whatever they were served.

A FASCINATION WITH RISK

QUATTRONE’S RELENTLESS DRIVE TO BE NO. 1 came to the streets of Philadelphia. He was inspired by his father, an Italian immigrant who worked in a clothing factory and made ends meet by wallpapering on weekends. Quattrone worked hard, too, and scored in the 99th percentile nationally on a scholarship entrance exam to win entry into the boys’ St. Joseph’s Preparatory School in inner-city Philadelphia. One thing Quattrone took away from St. Joe’s was an intellectual fascination with taking risks. In an essay on Homer’s *Odyssey*, he focused on the qualities that make strong leaders. “The point of his essay was that real leadership involves danger and the assumption of risk without assessing the pain and suffering it might cause the leader,” says H-

THE METEORIC CAREER OF FRANK QUATTRONE

Quattrone lived among the Valley’s techies, where his goal was to build a vast network of venture capitalists and entrepreneurs whom he could rely on to pass on scoops or to give him the inside track on landing the next deal.

1981 Quattrone joins Morgan Stanley’s corporate finance department in San Francisco. By 1986, he heads the West Coast Tech Group, advising Hewlett-Packard, Cisco, and Apple.

1995 In what many mark as the start of the tech frenzy, Quattrone manages Netscape’s IPO. The stock surges 150%, to 71, on its first day.

1996 Quattrone, frustrated by his lack of control at Morgan, bolts to launch Deutsche Morgan Grenfell Technology Group.

1997 Deutsch’s tech group enters the big leagues, and takes Amazon.com public. In 2 years, it goes from zero to \$200 million.

1998 Quattrone jolts Silicon Valley again by moving his team from

DMG to Credit Suisse First Boston. Quattrone gets juicy profit-sharing with CSFB and control over tech hiring.

1998-2000 As the Internet craze rages, CSFB manages 138 tech IPOs, including VA Linus and TiVo. From 1998 to 2001, Quattrone earns more than \$200 million.

2000 As the market begins to tank, questions swirl around Quattrone. Critics say he used hot IPO shares to buy business, a practice called “spinning,” and improperly pressured research analysts to write

positive reports about companies. Regulators begin investigating Wall Street, including CSFB.

DEC. 5, 2000 Quattrone writes the now-infamous e-mail urging colleagues to purge unnecessary files. Prosecutors allege that evidence in their IPO probe is destroyed as a result. Quattrone denies the charges.

MAR. 4, 2003 Quattrone resigns under pressure from CSFB. Two days later, the NASD charges Quattrone with spinning and pressuring analysts for favorable reports.

Quattrone denies wrongdoing.

APR. 23, 2003 Quattrone is charged by New York prosecutors with obstructing justice. The criminal allegations stem from his Dec. 5, 2000, e-mail.

APR. 23, 2003 CSFB agrees to pay \$100 million to settle charges related to IPOs. Among the allegations: that CSFB, under Quattrone’s leadership, improperly gave out shares in hot IPOs to win new business.
SEPT. 29, 2003 Quattrone’s criminal trial begins in New York.



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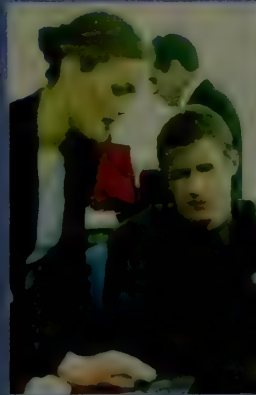
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Quattrone can count on an army of friends and associates to come to his defense. They say he's taking the fall for a flawed system

Bender, who taught him ancient Greek. "I gave him an A."

Quattrone got a chance to put his ideas to the test when he launched his business career. Wall Street considered Silicon Valley a backwater in 1981, when he earned an MBA from Stanford University Graduate School of Business, after graduating *summa cum laude* from the University of Pennsylvania. No major investment bank saw a reason to even put an office there. But Quattrone became obsessed with the Valley's nascent tech industry and, against the advice of senior investment bankers, decided that this was where he would make his mark. After landing a job at Morgan Stanley's branch office in San Francisco, he worked tirelessly to master the tech fundamentals—attending computer industry events, such as the Comdex trade show. Later, he moved his family to the Valley. "I'm sure people [on Wall Street] thought he was out of his mind," says Roger B. McNamee, a veteran tech investor at buyout firm Silver Lake Partners. "It was like Bob Dylan going electric. It was radical and beyond weird."

Not only did Quattrone live among the Valley's techies, he went native. His goal was to build a vast network of venture capitalists and entrepreneurs he could count on to pass on scoops about up-and-coming companies or give him the inside track on landing the next IPO. He was a world-class schmoozer, immediately identifiable by his mop of brown hair, crew-neck sweater, and bushy mustache. By the time he became head of Morgan Stanley's West Coast technology practice in 1986, he was inviting the Valley's players along on ski trips to Utah's Deer Valley and golf outings at Pebble Beach, Calif.

RIGHT STUFF

HE USED THE EVENTS to show the Silicon Valley crowd that he was just like them—and that he understood their financial needs better than the suits on Wall Street. He wasn't afraid to be a regular guy, either, charming his guests with raucous renditions of *Rocky Raccoon* during late night karaoke sessions. The crowd ate it up. It was the first time anyone from a big-name bank showed real interest in their fledgling industry. "Tech entrepreneurs related to Frank," says Harvey Jones, former CEO of Synopsis Inc., a chip design company in Mountain View, Calif., that Quattrone took public in 1991.

The formula clicked. He combined Morgan Stanley's sources and stellar reputation with his own rainmaking skills to line up some of the most coveted IPOs of the time, including Icon Graphics and Cisco Systems. With his star rising, he took over Morgan's Global Technology group in 1991. Even though his responsibilities spanned the globe, in 1994 he was the first to put an investment banking office in the Valley, when he transplanted his from San Francisco to Menlo Park, Calif., within walking distance of the Valley's venture-capital firms.

Collectively, these moves and his connections helped land Netscape IPO, a seminal event. Getting the business was a slam dunk for Quattrone, considering Morgan Stanley's reputation and his own connections with key players like Clark. On the day of the deal's pricing in August, 1995, he urged Netscape's management to double its offering price.

At 28 a share. It was risky, but they took the advice and saw their stock rise 150% on its first day of trading, the biggest jump in Wall Street's history at the time. It was the beginning of the era of excess—Quattrone and the tech economy.

The euphoria surrounding Netscape sent Quattrone's status into the stratosphere. He pushed for greater control at Morgan Stanley, stretching his leadership to research, where analysts issue reports on the financial prospects of companies. That had always been traditionally managed separately all along. When his Morgan Stanley bosses refused, Quattrone quit, taking eight colleagues with him to start up a new tech banking practice for Deutsche Bank Securities Inc., which gave him the control he craved. Within two years, in mid-1998, he had defected again, for an even better deal, this time at CSFB.

Quattrone's goal was to get ever larger slices of the huge payday the Internet boom offered, according to former associates. At CSFB, he cut a deal with management that in 1999 gave him and his employees at least 33% of the revenues the group brought in over \$1 billion, in addition to their salaries, of former Quattrone colleagues. The banking revenue tally was \$600 million that year, meaning Quattrone had nearly \$150 million to divvy up among select associates. The package, say critics, emphasized near-term results over long-term investment returns. On top of that payoff were profits that Quattrone and his senior bankers were reaping

in from their investments in venture-capital firms or startups, such as Web-site software maker Interwoven and e-mail maker eMachines. CSFB declined to comment on the pay package, but former employees say Quattrone made it rain money. "It was a nice place to be," says one of them with a chuckle.

To maximize the money flowing into his own group, Quattrone had created a distinctive structure that helped him win the greatest number of deals. The chiefs of investment banking research, and private-client services reported to him. That was



EUPHORIC CLIENTS Quattrone and his team engineered lucrative IPOs for Jeff Bezos (above) at e-tailer Amazon.com and Jim Clark at Netscape Communications



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he could call on—and control—any resource required and present a single face to the client. When he or other bankers pitched to CEOs to manage their IPO, they would take a team with them: investment bankers to talk about how much money they could bring in, analysts to show off their knowledge of the competitive landscape, and client-services people to offer up a menu of personal investment services. In other cases, commercial bankers were brought along to discuss raising debt.

The structure itself didn't break any laws, but Quattrone's accusers say the way he leveraged it violated both NASD rules and basic business ethics. For example: More than 300 accounts were created for so-called Friends of Frank, people who might give CSFB banking business in the future, and they were handed shares in upcoming IPOs, according to NASD. A senior executive at eGreetings Network Inc. was given 1,000 shares in VA Linux, for instance—and sold half of them a day later for a profit of more than \$83,000. A week later, CSFB took eGreetings public and collected \$1.6 million in fees, says the agency.

Quattrone has denied having any authority or influence over IPO stock allocations. His defense argues that CSFB's compli-

Quattrone's accusers say the way he leveraged CSFB's investment banking structure violated both NASD rules and basic business ethics

move to CSFB was prompted by unexpected changes at Deutsche and that most of Quattrone's clients came with him. "People didn't trust him, that wouldn't have happened," Chlopak. Deutsche declined comment.

When the going was good, there was little Quattrone did not do to win business. Peter H. Jackson, CEO of software company Intraware Inc., recalls that when he was preparing to go public, in late 1998, he told CSFB bankers that he was tired of being "dragged around to meetings like a mule." The next morning, a live mule was delivered to the lobby

of Jackson's office building in Orinda, Calif., with a bottle of wine tied around its neck. "Stop feeding me like a mule and pick CSFB," said the note signed by Quattrone. That touch helped CSFB win Intraware's business.

But when the bottom fell out of the market, Jackson says that the game changed abruptly. Intraware's stock plunged from a peak of 99 a share in early 2000 to less than 5 by the end of that year. Jackson, worried that his company might go bankrupt, was looking for financial aid and advice. But CSFB had already written him off. Ultimately, Intraware went through a massive downsizing, narrowly avoiding bankruptcy. Says Jackson, "I thought these guys would take care of me through the thick and thin. But I was like an ex-wife at the end of the point." Quattrone's defense says he was not

personally involved in Intraware and that CSFB did help other companies, such as Handspring Inc., when it was able to do so.

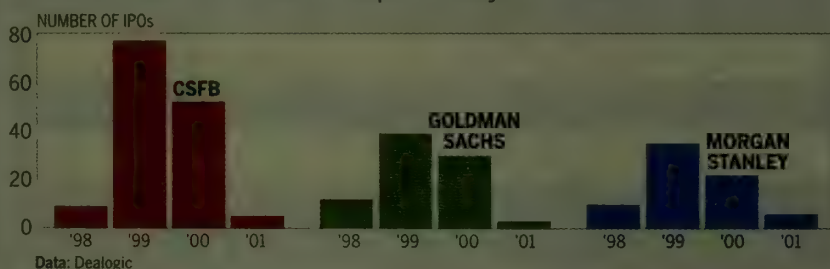
It wasn't long before Quattrone himself was everybody's target. As the stock market went into a tailspin, prosecutors and regulators began questioning all of Wall Street. Quattrone's money made him a target of intense scrutiny. Although CSFB stuck by him longer than most, his business melted away, it forced his resignation on May 1, just days before NASD filed charges. Federal prosecutors arrested him on Apr. 23, and the world was treated to yet another corrupt banker walk outside a Manhattan courthouse.

Now, seated at the defense table in the courtroom of Judge Richard Owen, Quattrone's days of wealth and power in Silicon Valley seem a long way off. Legal experts say he has a reasonable chance of being cleared because the criminal case hinges on one e-mail, and prosecutors will have to prove that he intended to hinder their probe. But it will be harder for him to escape censure by NASD because of the public outcry in the wake of corporate scandals. An adverse finding could result in him being banned from the banking industry for life and heavily fined. Like Odysseus, Quattrone was a leader who was not afraid to take risks. And now he's facing the consequences. ■

—With Steve Hamm in New York and Peter Burrows in San Mateo, Calif.

THE IPO ROLLER COASTER

After joining CSFB as head of technology banking in 1998, Frank Quattrone catapulted his company to No. 1 in managing IPOs in 1999. But the tech IPO market collapsed two years later.



ance department reviewed tech's private-client-services structure and deemed it legal and appropriate. Moreover, his defense says that CSFB's leadership worked to avoid conflicts between business units by having the chiefs of brokers and researchers also report to the heads of their respective divisions. Several former DMG and CSFB analysts defend Quattrone's integrity. J. William Gurley, formerly of DMG and now a venture capitalist, says Quattrone backed him when he issued a tough report on Netscape and gave a thumbs-down to the At Home Inc. IPO. As a result, DMG lost investment banking business. "These are real world examples where I made decisions with a huge negative impact on banking and was supported in full," he says.

FACING THE MUSIC

AS THE MARKET FRENZY INTENSIFIED, though, some in Silicon Valley lost faith in Quattrone. They say that instead of being driven by the region's entrepreneurial spirit, he was consumed by a thirst for power. An early indicator was a now-infamous letter he sent to clients in 1998 when rumors circulated that he might leave DMG. "We are here to stay. Please trust us," he pledged. Yet four months later, Quattrone and virtually his entire team jumped ship to CSFB. "For him, it was all about getting a better deal," says Richard E. Belluzzo, then CEO of high-performance computer maker Silicon Graphics Inc., which was in the midst of a Quattrone-managed spin-off of chip maker MIPS Technologies Inc. Robert A. Chlopak, a spokesman for Quattrone, says that the

BusinessWeek online For a commentary on why Silicon Valley should reform its business ethics, go to www.businessweek.com/magazine/extra.htm

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Board, Interrupted

New SEC rules will give investors clout with companies that ignore them

TIME WARNER INC. dodged a bullet earlier this year when a labor pension fund sought to inject a jolt of democracy into board elections. Angered by the media giant's accounting scandals and troubled 2001 merger with America Online, the fund submitted a shareholder resolution to let investors nominate directors. Management blew it off, citing Securities & Exchange Commission rules that let companies control board contests.

Not for much longer. By next year's proxy season, Time Warner—and a host of other targets of activists, from Lockheed Martin to Maytag—will face new SEC rules that make it easier for shareholders to get their candidates on the official ballot. "There should be some measure of shareholder participation in the selection if there is evidence that the wishes of a

large number of shareholders are being ignored," SEC Chairman William H. Donaldson told senators on Sept. 30. The new rules, expected to be approved and put out for comment on Oct. 8, are potentially some of the most far-reaching post-Enron reforms. Says Richard H. Koppes, a corporate governance lawyer at Jones Day in Sacramento: "This goes to the heart of corporate power."

Challenges to official director slates

will likely be rare, but the mere threat of them could weigh heavily on management decisions. Opening access to proxy will boost the clout of institutional investors, put teeth in shareholder resolutions, and shake up sleepy boards. Casualties: poison pills and takeover defenses that investors hate because they depress stock prices.

TRIGGER TIME

CORPORATE AMERICA is fiercely opposed to opening up the proxy, so the SEC is treading carefully. Under its plan, contested elections are likely to be approved only at the most unresponsive companies. The agency envisions a two-step process requiring a trigger that shows management is ignoring shareholder wishes before activists can nominate their own candidates. A vote to allow outside nomination or a big vote against a director nomination by management would be enough. The SEC may also allow elections at companies that ignore shareholder proposals backed by majorities, votes that are mostly advisory now.

Those requirements could trip up many corporate icons. Lockheed Martin Corp., for example, kept former Enron

Muscling into the Boardroom

Some major companies could be affected by new rules the SEC is now finalizing. The changes may allow shareholders to nominate company directors under certain circumstances:

1 Shareholder vote to give themselves right to nominate directors

TIME WARNER faced with such an attempt by fund this year

Frank Savage even after an im-
e 28% of shareholders voted to
m off the board. Boeing Co. has
to repeal only one of three anti-
er measures that shareholders
vice voted to dump. Overall, few-
a dozen of the record 155 gover-
resolutions from investors
this year have been adopted by
ements, according to the In-
Responsibility Research Center.
ady, some companies are re-
ng to the heat. Alcoa, Tyco Inter-
al, and Hewlett-Packard made
sions on golden parachutes after
olders voted to curb CEO pay.
Carol Bowie, IRR's director of
ance research: "Ignoring share-
votes isn't a viable option any-
Nor is a nonchalant attitude to-
electing directors. The plan could
companies to be more careful
whom they pick.

os fear the changes will put them
mercy of investors—and could
hem to adopt policies they don't
e are in the company's best inter-
is. No good director wants to run in a
oted election. You would do every-
to avoid it," says Henry A.
McKinnell Jr., chairman and
f Pfizer Inc. Studies show that poi-
lls and staggered boards result in
takeover offers, says a top May-
ficial, explaining why its board
complied with shareholder votes
h such measures.

usiness will lobby hard for the SEC
it shareholders' ability to nomi-
candidates. But labor and public
on funds, on a roll after helping to
the New York Stock Exchange
man Richard A. Grasso, will be ag-
ng just as vigorously for easier ac-
That leaves the SEC walking a fine
between empowering investors and
oting business. Shareholders will
ave to clear hurdles to get their
dates on the ballot—but they
be running into brick walls. ■

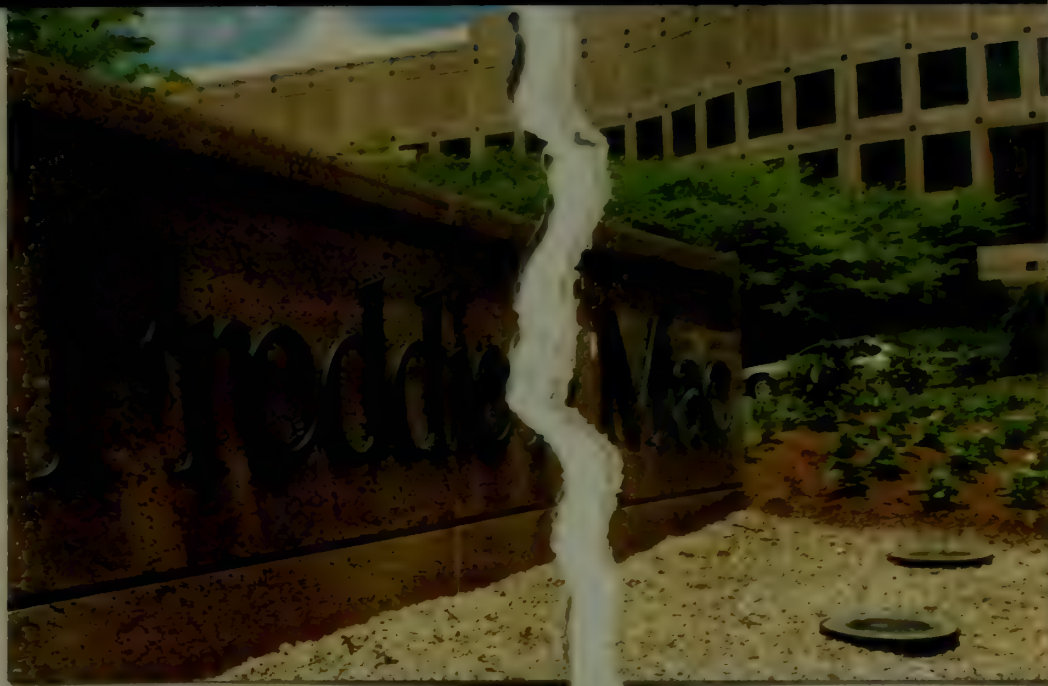
—By Amy Borrus in Washington,
with bureau reports

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MARTIN
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3 Management
fails to
implement a
resolution approved
by shareholders

BOEING and **MAYTAG**
kept anti-takeover
poison pills that were
voted down



COMMENTARY

BY PAULA DWYER

Breaking Up Is Good to Do

Fannie and Freddie have too much on their plates

WITH CONGRESS ON THE VERGE OF moving oversight of Fannie Mae and Freddie Mac from the obscure Office of Federal Housing Enterprise Oversight (OFHEO) to the Treasury Dept., efforts to rein in the two housing-finance giants are likely to grow. Even Federal Reserve Chairman Alan Greenspan, sources say, joined the chorus of Fannie and Freddie

critics last month, when he sought to persuade Treasury Secretary John W. Snow to slow the two companies' growth by calling for an increase in a key capital standard.

Snow demurred. But he did open the door to a tougher capital rule on Sept. 10, when he asked Congress for more flexibility to adjust the standard if needed.

Greenspan may have lost that battle, but he should continue to fight the war.

While boosting capital standards is a positive move, the chairman should go a step further and push Congress to break both Fannie and Freddie in two.

The resulting four government-sponsored enterprises (GSEs) would carry on the traditional mission of increasing homeownership, especially for low-income and minority families looking for a piece of the American Dream. Having four GSEs would lower the risk of an unexpected financial

shock—and a government bailout.

Why worry about a bailout? The rapid growth and enormous size of the two GSEs is enough to make a regulator sweat. With investors believing that the government will guarantee their debt, Fannie and Freddie pay about 0.30 percentage points less than most banks to borrow. So they borrow like crazy to buy mortgages from banks and thrifts, which are then free to lend again. Then they package loans into mortgage-backed securities (MBS), which they guarantee and sell to investors. They now stand behind about \$2.65 trillion of MBS.

RISK MAGNETS But that's only part of what they do. They also use their access to cheap money to hold in their own investment portfolios the very mortgages that they securitize. In essence, they're putting their eggs into their own baskets, and concentrating mortgage-lending risk instead of spreading it, as they're supposed to do. They now have a combined \$1.6 trillion in such investment portfolios, which, to the delight of shareholders, historically produce higher returns than the MBS business.

By breaking up the cozy duopoly, Congress could make the GSEs compete more for mortgages—and ensure that risk is spread more widely. Fannie itself is the product of a breakup: In 1968, Congress split the Federal National Mortgage Assn. into today's Fannie and Ginnie Mae, a government agency that guarantees Federal Housing Administration and Veterans Administration loans.

Their hedging needs whipsaw the market

However, a breakup solves only half the problem. Together, Fannie and Freddie run a \$4 trillion book of business on a tiny capital base of \$60 billion. Such leverage raises the specter of a crisis like the one in the 1980s when some 1,400 savings-and-loans had to be closed or merged, at a cost to taxpayers of \$200 billion. "Any problem in the capital markets affecting these firms could become very large, very quickly," said William Poole, president of the Federal Reserve Bank of St. Louis, in a

March speech. Because of the scale of their obligations, it could happen in "a matter of days, or even hours."

What's really got the Fed worried is that the markets haven't forced the two companies to hold more capital as a cushion against unforeseen shocks. When Freddie forced out three top executives because of an accounting scandal in June, the markets barely reacted. And credit-rating agencies did not lower their ratings. Says a Fed economist: "The mechanism of market discipline has been disabled because investors believe the government will step in and save them."

That's why Greenspan wants the GSEs to hold more risk-based capital—the amount they need to ride out adverse changes in interest rates or a sudden inability by homeowners to repay loans. Currently, the GSEs must have enough capital to function under severe stress, defined as a sudden 75%

How To Fix Fannie And Freddie

These steps would reduce or spread the risks posed by the two housing finance giants:

- Split them each in two, creating four companies of roughly equal size
- Raise the minimum risk-based capital they must hold against lending
- Improve oversight by making Treasury their regulator
- Increase transparency about their hedging activities

increase, or a 50% plunge, in rates. means \$18 billion in risk capital for Fannie, and \$4.7 billion for Freddie amounts both GSEs easily exceed. S Fannie Chairman and CEO Franklin Raines: "By any measure, we have more capital than the typical bank for the risk we have."

Critics disagree, arguing that capital standards would have to be at least higher, and up to 50% higher for risk mortgages, to match those of commercial banks. "The GSEs are well managed by smart people," says a Fed economist. "But that's not the same thing as having adequate capital."

Fannie's and Freddie's narrow specialty gives them one big advantage. They have built up more expertise than most banks in managing risk, especially the risk that homeowners will prepay mortgages. That, Fannie and Freddie argue, means less stringent capital requirements should apply to them.

Because of their huge borrowings, Fannie and Freddie must do massive

amounts of hedging with derivatives, such as interest-rate swaps. Together, they held more than \$1 trillion worth in 2002. That's more than 10% of all such instruments in use by financial institutions. A February OFHEO study concluded not only might the GSEs' demand for hedges outstrip supply in the near future, but that a financial problem at one GSE could quickly spread to counterparties. At highest risk would be the seven largest derivatives dealers—J.P. Morgan Chase, Citigroup, Goldman Sachs, Deutsche Bank, Lehman Brothers, Merrill Lynch, and Morgan Stanley—that take the other side of 60% of Fannie and Freddie hedges. And in an August study, Fed economists concluded that the hedging needs of the GSEs are so large that they whipsaw the rest of the market and exaggerate movements in interest rates. Says a Fed source: "Greenspan thinks Fannie and Freddie are causing market distortions."

FIONA AND FRANKIE The solution? Congress could charter new GSEs and give them seed capital. A new "Fiona Mae" would get half of Fannie's assets and liabilities and half its staff. A new "Frankie Mac," likewise, would inherit half of Freddie's balance sheet and expertise. Divvying up derivatives, some of which do not perfectly match the assets being hedged, is trickier but doable. Congress might have explicitly guaranteed the junior GSEs' debt to get them on their feet. And while the junior siblings might cause some market disruption at first, their benefits would soon be apparent—more robust competition for mortgages and a spread of four ways instead of two. That way, human error or a fateful management mistake at one—exactly what sophisticated risk models can't anticipate—wouldn't drag down the others.

Fannie and Freddie are clearly too big to fail. But their contribution to the civic good is also too important to lose. Breaking them up, and forcing them to hold more capital, would reduce notably the risk of an unexpected shock bringing the whole system down. ■

—With Rich Miller in Washington

Moving Out of the Ivory Tower

New boss is overhauling TIAA-CREF. Will it remain a shareholder activist?

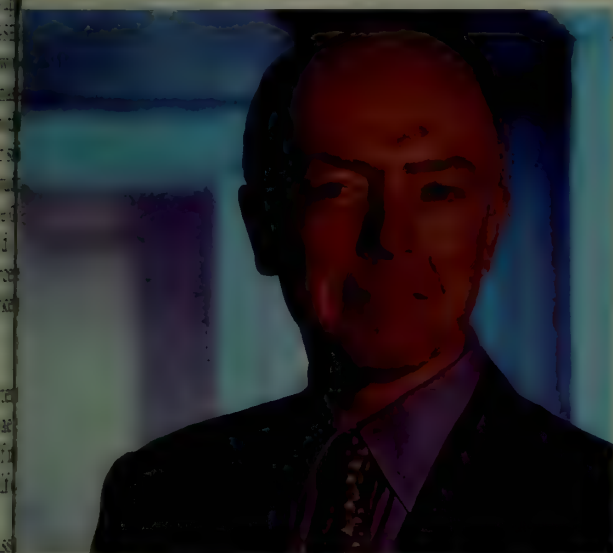
S EVEN TOP LIEUTENANTS replaced. Fully 8% of the workforce laid off. The rank-and-file told that much about their firm is about to change. And now, more job cuts in the works. Sounds like the sort of shakeup that Lynch & Co. might undertake? Well, it's happening at Teachers Insurance & Annuity Association College Retirement Equities Fund, TIAA-CREF, the

largest provider of pension plans for colleges and other nonprofits, which manages \$290 billion in assets. New Chairman and Chief Executive Herbert M. Allison Jr. is putting the money-management firm through the wringer in order to turn it into a sharp-elbowed and agile financial-services outfit. And it just so happens that he worked at Merrill for 28 years, resigning as President in 1999.

Change is overdue. For decades, the nonprofit, renowned as a champion of good corporate governance, was run like one of the heavily endowed universities it serves, with effectively tenured employees and huge ivory-tower offices. As its costs rose, its rivals gnawed steadily at its market. In July, New York State dropped the firm for its college-savings plan. Fewer younger college staff members are signing up with TIAA-CREF because schools also offer Vanguard Group and Fidelity Investments as options. And even those that pick TIAA-CREF for their plan are turning to banks and others for investment advice. To top it off, the equity funds that the firm began offering in 1997 in a bid to become a major fund outfit have performed poorly.

Critics charge that Allison is on a mission to Merrillize TIAA-CREF, turning it into a typical financial firm. He dismisses the notion. "This is a dif-

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ferent culture with a different mission; comparisons don't have much value here," he says.

What Allison is doing does have a familiar ring, however. He's streamlining reporting lines and slashing costs; never before had the firm laid off employees. And he's planning to offer more comprehensive financial advice, Merrill-style. Instead of one-size-fits-all, the firm will tailor investment advice to each market segment, from millionaires to small fry. Meantime, its mutual funds will be sold to the general public through other financial-services companies. TIAA-CREF is even considering expanding into cash-management accounts—a banking service that Merrill pioneered in the 1970s.

Right now, the odds are on Allison to pull off his revamp. He believes he has the right strategy: boosting assets by focusing more tightly on TIAA-CREF's core market of academic and nonprofit institutions. "We know that market better than anybody," he says. He has worked hard to win over employees, answering dozens of e-mails daily through what some now call "Herb Mail." The board is behind him. "The effort of management is to make TIAA-CREF a more profitable enterprise," says former Securities & Exchange Commission Chairman Arthur Levitt, a board member.

A FINE LINE

Still, Allison is walking a fine line between expanding the business and maintaining its above-the-fray practices. Soon, he will face these issues without revered Chief Investment Officer Martin Leibowitz, who retires in February. Already there's grumbling over whether TIAA-CREF's signature efforts to improve corporate governance will fade. TIAA-CREF watchers are scrutinizing Allison's every move, from whether he'll charge marketing fees on mutual funds (his predecessor, John H. Biggs, thought them unseemly) to whether his pay package meets governance guidelines (it'll be revealed in November in the proxy statement). At the annual meeting Nov. 13, dissident members plan to press Allison to boost the commitment to shareholder activism. But Vanguard founder John C. Bogle remains a fan: "They are still the gold standard." If Allison can balance these missions, he'll put TIAA-CREF, as well as members' retirements, on a firmer footing. ■

—By Emily Thornton in New York

COMMENTARY

BY DAVID HENRY

FASB: The Devil Is the Details

The board is drowning in fine print—once again

THE FINANCIAL ACCOUNTING Standards Board's mavens have a problem. They want to issue clear, broad principles that accountants can apply to the books of Corporate America. But they keep getting bogged down in fine print. They want to believe companies will abide by the spirit of overarching standards, but they know that finance whizzes will exploit every loophole. In September alone, FASB

stumbled over three key issues. It slowed its drive to compel companies to expense stock options; it wants at least another three months to work out the details. It proposed five more amendments to rules on off-balance-sheet entities that had already been altered five times since January. And, instead of fixing pension-plan rules to stop companies from distorting earnings, it produced a stopgap proposal that would only require more disclosure.

For FASB, the devil isn't in the details—it is the details. The board says it's hurrying to emphasize the principles in the generally accepted accounting principles, or GAAP, that U.S.-listed companies must follow. In practice, it's reverting to its bad old habits of trying to second-guess every conceivable trick that Wall Street might dream up.

That's a thankless task that creates endless delays and complicated rules larded with exceptions. Board Chairman Robert H. Herz complains: "You write something with two conditions and [accounting firms] think of a third. You start getting rules

Set general principles; let the SEC sweat the nitty-gritty

begetting rules begetting rules. We are trying to avoid that at all costs."

Herz contends that FASB hasn't fallen into that trap with its amendments to the new off-balance-sheet standard, which was supposed to be a more streamlined, principles-based edict.

But the changes are minor. The standard, which was 66 pages long when adopted in January, will grow about 20 pages after the tinkering. Says Lynn E. Turner, accounting professor at Colorado State Univer-



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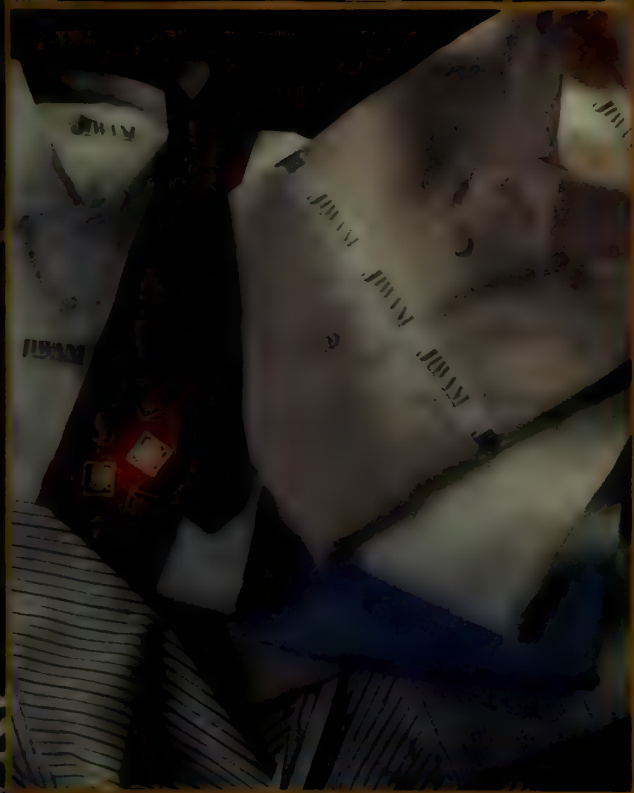


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and a former chief accountant at the Securities & Exchange Commission: "It is the start of death by 1,000 cuts. People will say they haven't figured it out yet so why don't you defer it for another year."

What Herz needs to do is keep the board focused tightly on setting general principles and let another body decide how they should be applied to different situations, much as Congress defers to the courts to interpret the laws it passes.

THE PIECES ARE IN PLACE We wouldn't have to create an accounting court. That idea was floated over 40 years ago but has gone nowhere. It would likely produce only rich lawyers—and serious delays in deciding big issues. Happily, the mechanism for doing what's necessary is readily at hand: The SEC has given hundreds of interpretive opinions over the years. Sometimes auditors and CFOs ask for its views on how to apply GAAP to their specific situations. Sometimes the SEC spots companies violating the spirit of good accounting when it checks their financial reports.

The burden on the SEC wouldn't be all that great. At present, its decisions are mainly kept under wraps, communicated privately to the parties involved. They need to be published so that they're readily accessible as guideposts to execs and accountants. Most big auditing firms have their own collections of SEC rulings and some share the significant ones with their peers. But the decisions are too important to circulate just within a tight circle.

Herz insists that FASB is "on course" toward more principles-based accounting. But he wants to keep a tight hold on FASB's oversight of GAAP. For consistency's sake, he doesn't want to give up the option of trying to anticipate, and answer, any question that might come up about how to apply its standards to all manner of transactions. And he bristles at the idea of anyone else interpreting board's principles, even if it eases his burden.

The move to principles-based from rules-based accounting was always going to be tough—especially in America's litigation-prone culture. But by refusing to budge when it expects other players to change their ways, FASB will prolong a difficult process.



McNEALY
He has reversed some '90s move

Can Sun Weather The Dark Days?

Even before its huge loss, CEO McNealy was putting in place a comeback strategy

AS PROFIT REPORTS GO, this one was a doozy. On Sept. 29, giant Sun Microsystems Inc. announced that in the first quarter of fiscal 2004, which ended the day before, it would record a net loss of as much as \$304 million, compared with the \$61 million loss that Wall Street had been expecting. Ouch. The red ink, together with a \$1 billion noncash charge to the previous quarter, signals ominous days ahead for the once-heralded innovator.

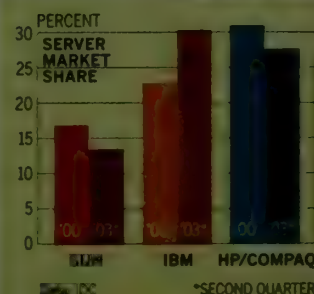
Boil all the financial issues down, though, and they amount to this: For the last two years, CEO Scott G. McNealy and Sun have had difficulty selling what customers want—

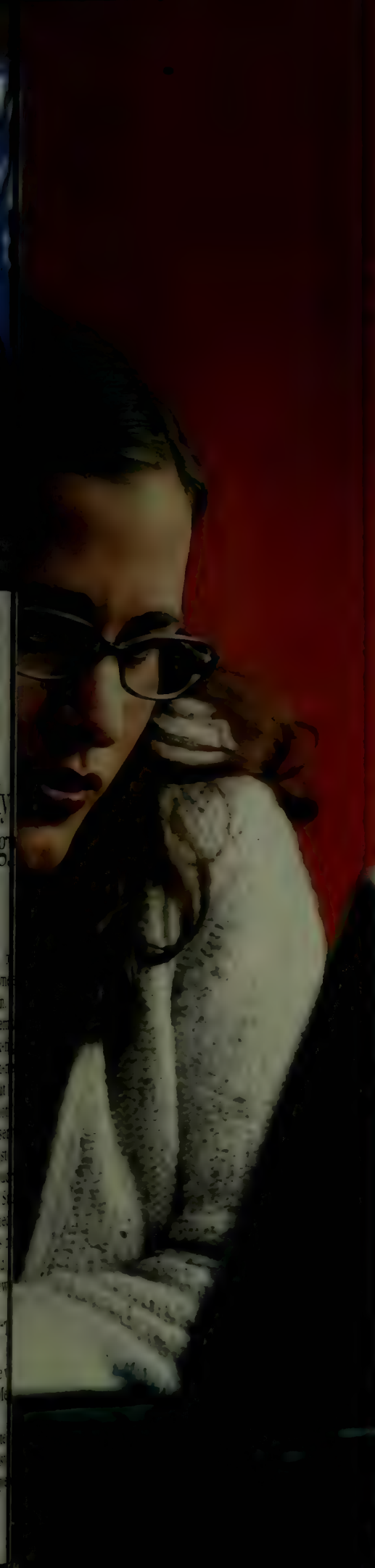
low-cost computing based on open source technologies that aren't owned by a single company, such as Sun. The company became one of the behemoths of Silicon Valley by selling six-figure computer servers that run Sun's software on Sun-made chips. But the past two years, the industry's hottest servers have been \$2,000 to \$10,000 servers that run on Intel chips and low-cost Unix software made by companies such

as Red Hat and SuSE. While Sun shunned Linux, its market share tumbled, and rivals IBM, Hewlett-Packard, and Dell gained ground. "They just missed it," says analyst Steve Milunovich of Merrill Lynch & Co.

But don't write off McNealy & Co. just yet. Over the past 20 years

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Sun has floundered two other times, and the CEO has managed to right the ship. He still has a chance to do it again. The irony of the recent financial hit is that it comes just as McNealy has finally put a potentially winning strategy in place after two years of missteps. In May, Sun introduced a host of competitive, low-cost servers that use Intel chips and Linux software from Red Hat and SuSE. That should help minimize customer defections to low-end rivals. The company also is making progress in its push into software, which carries much higher margins than the hardware business. On Sept. 16, Sun debuted a package of integrated software with simple, flat-rate pricing that could boost revenues and profits.

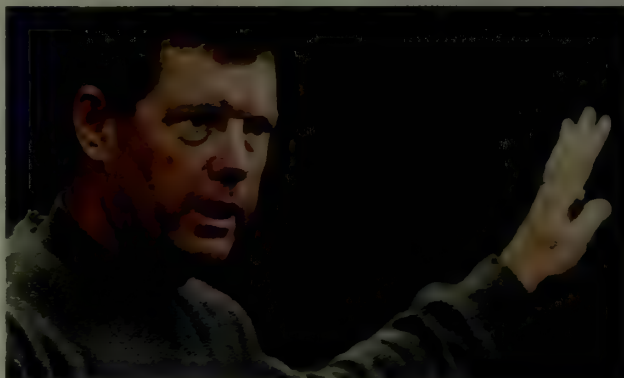
SPEED AND SIMPLICITY

LONGER TERM, McNEALY IS continuing to do what he has always done—swing for the fences. Despite rising criticism, Sun is maintaining its \$1.9 billion annual research-and-development budget. That's 18% of Sun's expected revenues this fiscal year, up from 10% in 2001. McNealy wants to spend big on new ideas that could make the company a tech leader again. Sun is working on chip research that could create a hundredfold jump in processing speeds and software that would deliver computing power as simply as electricity. Either of those breakthroughs could brighten Sun's long-term prospects.

No question, McNealy still has much work to do. Sun has lost so much momentum that customers may be reluctant to buy from the company because they fear it won't be around to support its products. In a recent survey, Milunovich found that a third of Sun customers are considering moving to other companies' products. Customers also may question McNealy's long-term commitment to Linux, considering his 11th-hour conversion. And he still needs to get Sun's costs in line. Although Sun eliminated 6,000 of

43,000 jobs over the past two years, it has not cut costs as deeply or aggressively as rivals. As it stands, Sun is expected to lose \$302 million for the fiscal year ending in June, 2004, according to Banc of America Securities. That's on \$10.4 billion in revenues, down from a peak of \$18.2 billion in fiscal 2001.

Still, some customers think Sun is back on track. Mark Dickelman, chief technology officer at Bank One Corp. in Chicago, says Sun is taking security and reliability more seriously than its rivals. The result is that Bank One is considering boosting its



spending with the company. "They're talking about things that really matter," says Dickelman.

Sun may be getting its strategy together at the right time. While corporations have kept their purse strings tight over the past three years as the economy has sputtered, they're now starting to ramp up spending on tech gear. According to the Commerce Dept., corporate tech expenditures rose 3.2% in the second quarter, the largest increase since spending began to tick up last year.

The strategic repositioning has meant wrenching change for McNealy and Sun. In addition to selling Red Hat and SuSE Linux on Sun-made boxes, McNealy is

protecting his flank on the low end by using Sun's own Solaris operating system on cheap servers running on Intel chips. The move for Sun, a pride-swallowing move for Sun, stopped pushing Solaris for Intel in the late 1990s to focus on its own chip. Nealy, not someone who readily eats his words, admits that was a mistake he didn't exactly jump on the bandwagon. He said at the product's launch in May.

Making Sun a serious player in software has been no easier. Last year, after years of half-hearted efforts, Sun finally began the hard work of improving its so-called

structure software, which acts as the digital foundation for big e-business systems. The strategy made sense since business software carries gross margins near 80%, compared with 30% for most hardware execution, however, was terrible. Going into this year, Sun was a distant third behind IBM and BEA Systems in infrastructure-software sales. And Sun, for all its talk of selling an integrated software product, didn't have all the pieces well together until this summer.

Now all those software pieces are tied together. Sun is offering a simple \$100-per-employee pricing that it believes can cut through the confusion in the software industry. Pricing can be based on anything from a server's processing speed to the number of people using the software over the Net.

So there may yet be a path out of the woods for Scott McNealy and Sun. Nealy has a solid strategy in place. He has to make it work. ■

—By Jim Kerstetter in San Francisco

Sun has kept R&D steady, though revenues have dropped

The **Fix-It** Plan

Sun Microsystems has a three-pronged strategy to reignite revenues, which have dropped about 50% over the past two years

PROTECT THE LOW END

Sun has been bleeding market share because it has had few servers in the \$2,000-\$10,000 range. In May, it started fighting back with cheap servers that run on Intel chips and use either Linux or Sun's Solaris software.

INNOVATE ON THE HIGH END

The company is maintaining its \$1.9 billion R&D budget to create cutting-edge technologies. It's working on chips that could be up to 100 times faster than existing chips and software to manage utility computing projects.

EXPAND ITS SOFTWARE BUSINESS

Sun is out to boost software sales. It has stitched together products and debuted simplified pricing. Merrill says software could rise from 5% to 9% of revenues in two years, adding \$400 million to gross profits.

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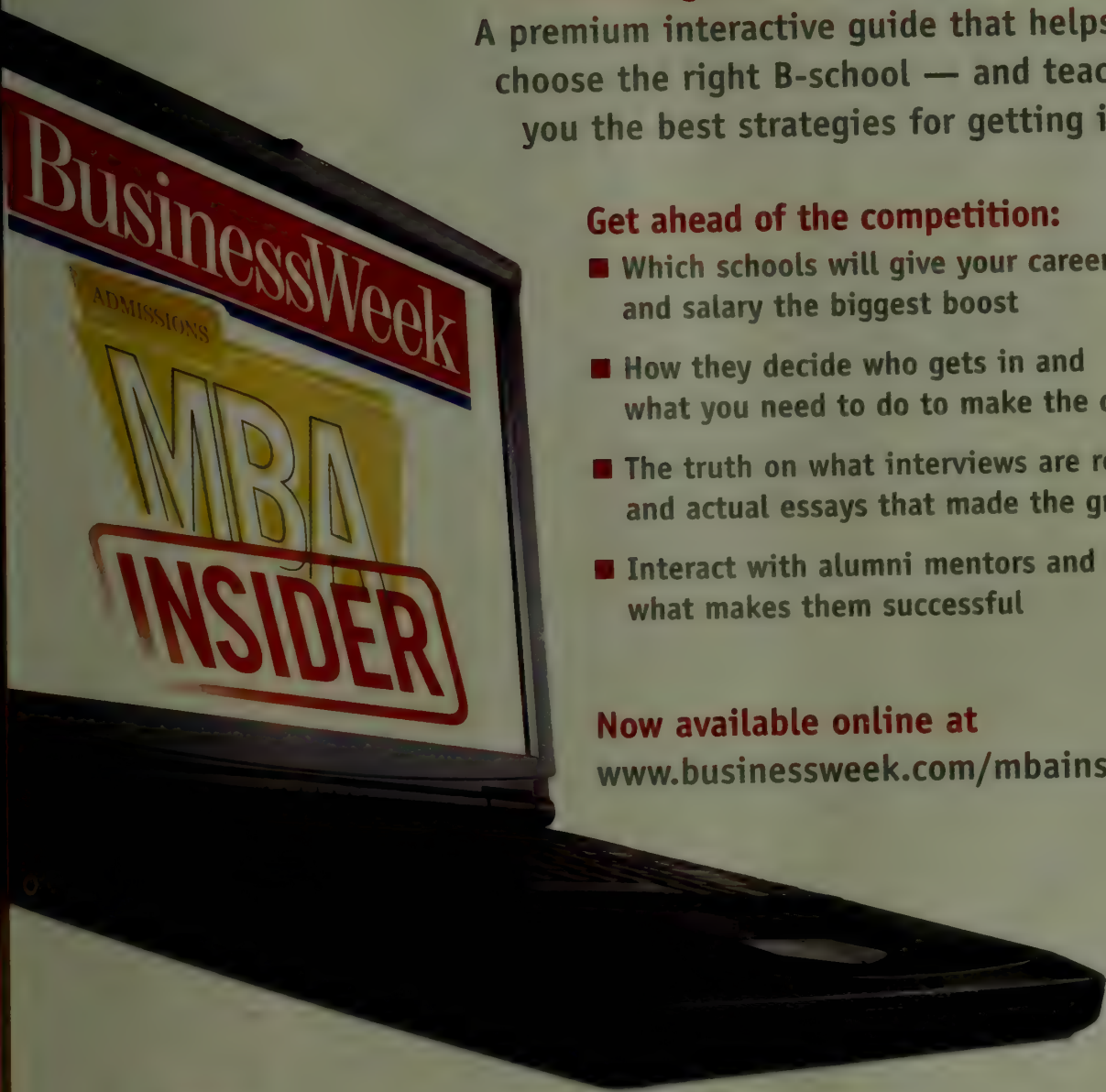
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The Split Over School Vouchers

Some black Dems in D.C. are defying liberal groups to back a pilot program

VIRGINIA WALDEN-FORD, a black single mother of three, felt helpless as she watched her 14-year-old, William, fall in with the wrong crowd at Roosevelt High School in Washington, D.C. It was more self-education than rebellion, her son explained; his new friends were protecting him in the violence-plagued hallways. When William arrived when

neighbors and relatives pooled enough money for nearly half the \$5,000 tuition at Archbishop Carroll High School, a nearby private school. An archdiocesan scholarship made up the rest.

William graduated with top grades in 2000, and the experience got Walden-Ford thinking: "While we are working hard to reform the public schools, why not give other parents the same options?" She went on to form the 3,000-member DC Parents for School Choice. And now

they're backing a Senate plan that would provide \$13 million in federal money to D.C. parents—enough to pay for \$7,500 scholarships at area private schools for 1,700 low-income children chosen by lottery. A similar bill passed the House by one vote in mid-September, and an amended voucher bill has been gaining support in Senate debate.

Those prospects have made the nation's capital the latest arena for the debate over vouchers. They are also casting a spotlight on a widening fissure in the African-American community over what proponents now call "taxpayer-sponsored scholarships." For years, black leaders around the country, most of them Democrats, have been steadfast opponents of vouchers. But a growing number are frustrated by the slow pace of school reform. So they're signing up with GOP stalwarts to endorse vouchers for the worst urban schools. Joining them are such liberal voucher converts as Senators Dianne Feinstein (D-Calif.) and Robert C. Byrd (D-W. Va.).

LOCAL BACKERS

THE D.C. VOUCHER BILL in Congress has split the black community as never before. Stumping for a new law are Washington's popular mayor, Anthony A. Williams, D.C. Board of Education President Peggy Cooper Cafritz, and the chairman of the city council's education committee, Kevin P. Chavous—black Democrats one and all. Meanwhile, D.C.'s Democratic delegate in the House, Eleanor Holmes Norton, remains fiercely opposed, as do most major civil rights organizations. "Vouchers are no substitute for a quality program for all," says the Reverend Jesse L. Jackson, president of National Rainbow/PUSH Coalition. "It is a rope for a few rather than a net for all."

Proponents hope the support of some black leaders will add momentum to the stalled voucher movement. Nearly a decade after the effort got going, only Cleveland and Milwaukee have voucher programs that are similar to the D.C. scheme. President Bush and GOP leaders in Congress have been trying, with little success, to push a national voucher plan, or at least more experiments, ever since the Bushies took office.

Now conservatives are hoping their black allies will help undercut the criticism that vouchers are primarily a ploy by the Christian Right to get money for religious schools. Education Secretary Rod Paige joined Williams at a recent National Press Club speech on the D.C. bill, and Senate Majority Leader Bill Frist (R-



WILLIAMS HOLMES NORTON

Community Divided

Some black leaders are starting to endorse the use of public funds to send desperately poor inner-city children to private schools

OPponents SAY:

SCHOOL REFORM will never reach the level of success needed to help low-income students trapped in inner-city schools.

PRIVATE SCHOOLS offer a safer learning environment and could help break the cycle of poverty and crime.

OPponents SAY:

VOUCHERS of any sort deprive public schools of money, the best students, and the most committed parents.

PRIVATE SCHOOLS lack accountability and standards: For instance, they're not covered by the new federal student testing law.

Data BusinessWeek

Tenn.) appeared with Williams at a press conference. Williams explains his pro-voucher position by comparing the city's schools to "a slow-moving train wreck" and linking the city's 50% dropout rate to its 200 homicides a year.

LIBERAL OBJECTIONS

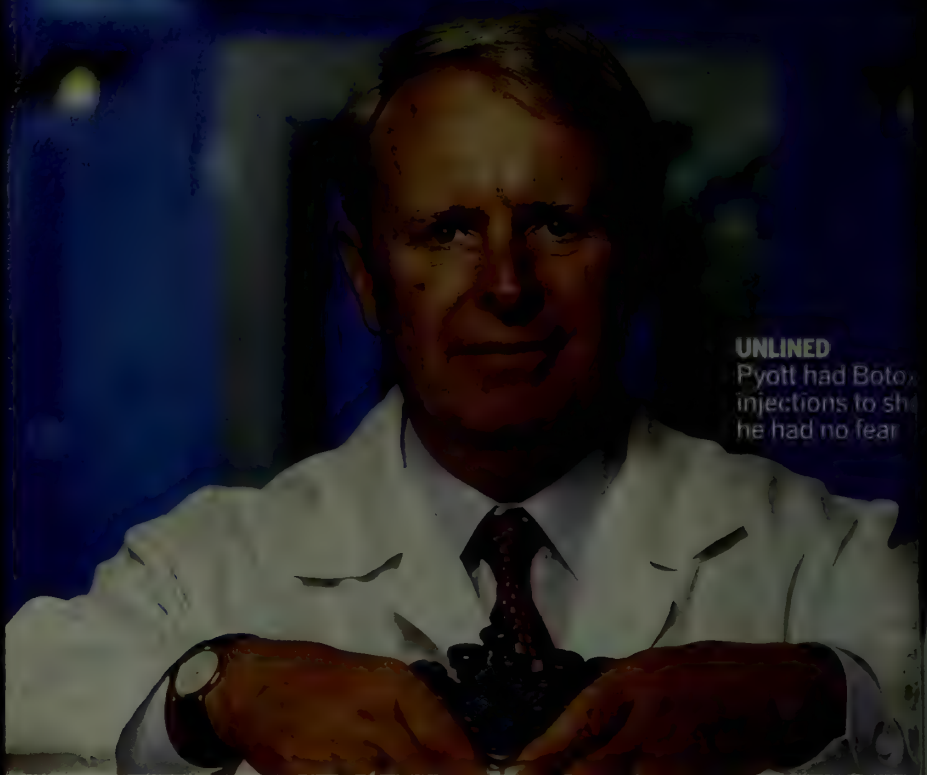
VOUCHER ADVOCATES also have crafted a bill that blunts many of the traditional liberal objections. To counter criticism that vouchers divert money from public schools, the Senate would sweeten the \$13 million earmarked for vouchers with an additional \$26 million for D.C. public and charter schools. It also requires voucher students to take the same standardized tests that are mandated by the federal No Child Left Behind Act for the public school system. In addition, private school teachers would be required to have college degrees. While several of Washington's elite private schools opted out of any such arrangement, Cardinal Theodore E. McCarrick, archbishop of Washington, quickly agreed to allow testing of voucher students in the Catholic schools, which make up a third of the area's private schools.

The stark economic and racial contrasts of Washington add fuel to the voucher controversy. The city's ruling elite, including those few members of the black middle class who haven't fled the city, almost always send their children to private schools. That has pushed the equity argument front and center. Writes *Washington Post* columnist William Raspberry: "If choice is good for middle-class children, why is it bad for poor children who, without some sort of subsidy, may find themselves stuck in underperforming schools?"

Still, the new alliance between blacks and conservatives may go only so far. Williams and most other black converts to vouchers don't endorse the GOP's view of vouchers as a way to break teacher-union monopolies. Instead, black voucher supporters point out that the Senate bill narrowly targets poor families with children in schools designated as failing. "Why should the poor child not have the same access as the wealthy child?" asks Feinstein. Right now, no major black group is embracing vouchers. But if Congress makes Washington its first federal voucher pilot program and more local black leaders sign on to the idea, vouchers could be back on the national agenda. ■

—By Paul Magnusson in Washington

Management Innovator



UNLINED
Pyott had Botox injections to show he had no fear

He Bet on Botox—And Won

David Pyott transformed sleepy Allergan. Where is he taking its blockbuster drug

ALLERGAN INC. CEO David E.I. Pyott does not need an injection of his company's wrinkle-erasing drug, Botox. At 50, he is blessed with a nearly unlined face. Nevertheless, Pyott happily underwent a Botox treatment last year at a session for Allergan distributors in Monaco. "I wanted to demonstrate I had no fear [of the drug]," says Pyott; after all, Botox is derived from the same paralyzing toxin that causes botulism. "And I want everyone here to feel good about the fact that I'm in touch with the details of what we do."

Thanks to Pyott's hands-on management, and to the small wonder that is Botox, a lot of people are feeling good about Allergan these days. And looking

good, for that matter. From the moment he took the helm in 1998, Pyott had grand ambitions for a company then known only for its eye-care products: He wanted Allergan to be a cutting-edge pharmaceutical leader. Little did he know that Botox, all but ignored by his predecessor, would not only help transform the company but also become a cultural phenomenon.

Allergan originally purchased Botox in 1991 from an ophthalmologist who was developing it to treat rare muscle disorders such as uncontrollable blinking. Doctors who prescribed Botox had reported its surprising power to erase wrinkles, and dermatologists were using it under the table on some elite patients. But Allergan was spending virtually nothing to develop the drug for cosmetic use. "This eye-care company fell into an opportunity with its

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closed," jokes Pyott, a 21-year veteran of Sandoz, now part of Novartis. It was he who figured it was time to put some money behind Botox to see what it could do. So he cut overhead costs by one-third, cast off slow-growing products such as contact-lens solution (much to the consternation of some execs), and in 1999 boosted spending on research and development 38%, to \$135 million—much of it devoted to the fledgling product.

THE EYES DON'T HAVE IT

PYOTT'S DECISION PAID OFF in 2002, when Allergan, based in Irvine, Calif., won Food & Drug Administration approval to market Botox as a wrinkle reducer. The drug's sales jumped from \$309 million to \$440 million that year and are expected to reach \$540 million this year, which means Botox would account for one-third of Allergan's \$1.7 billion in estimated total revenue. The company's profits are expected to increase 24%, to \$305 million, this year, and investors have pushed the stock up 35%, to 79, since January.

Botox, of course, has become a sensation—especially in Hollywood, where gossip columnists say that even Arnold Schwarzenegger has gone under the needle. The word "Botox" was recently added to the *Oxford English Dictionary*. Pyott is staggered by the product's success. The CEO, with his understated British humor, has one word for Wall Street analysts who said Botox would never

amount to more than a niche drug: "Oops."

Pyott believes Botox can do more than just take a few years off your face. Allergan is testing Botox as a remedy for a host of diseases, including migraines, overactive bladder, chronic back pain, and excessive sweating. Many physicians agree that the ability of Botox to block nerve activity in the areas where it is injected could someday make it a cure-all. "It will become the wonder drug of the century," says Andrew Blitzer, professor of clinical otolaryngology at Columbia University's College of Physicians & Surgeons. But already the federal government is concerned that Allergan may be pushing Botox a bit too hard. On June 23, the FDA warned Allergan that its print ads made overly broad claims about the drug's ability to reduce wrinkles and downplayed potential side effects, which include droopy eyelids, nausea, and respiratory infections. Pyott says Allergan didn't intend to break any rules and is talking with the FDA about how to respond to the complaint.

This is not the first time Pyott has faced controversy at Allergan. You can't expect a 53-year-old company to rethink its business without some initial discomfort. For Pyott, that moment came in January, 2002, when he decided to spin off the unit

that makes contact-lens production medical devices. It was not a decision taken lightly: The division accounted for one-third of sales. The problem wasn't growing more than 2% a year, but it felt as if he was chopping off one arm," says Allergan co-founder and former CEO Gavin S. Herbert, now on

board. Pyott felt the decision was a drag on the company's other, promising, side: drug development. "We were like a catamaran with two boards—one going in one direction and the other 20 degrees off," Pyott says. "Imagine the resulting effect."

Pyott has never been far away from change. After leaving Sandoz, he worked his way up through the nutraceutical

division in Barcelona, Vienna, and Lumpur before moving to Minneapolis to take on his toughest task: revamping a struggling unit that distributed pharmaceutical products to hospitals. He promoted himself acting manager and expanded the sales force. Within five years, Sandoz' market share tripled. Pyott's 10 years of pharmaceutical experience made him an odd choice for Allergan, but his no-nonsense style captivated the board. "David is this very quiet guy who is a strategic thinker with tremendous drive," says Les Schaeffer, CEO of WellPoint Health Insurance works and an Allergan board member.

The CEO, who speaks four languages and has lived in 10 countries, inherited his wanderlust from his parents. When he was 3, his family left England for Scotland, where his father managed a sugar plantation. Four years later, they moved to Germany. During his college years, he roamed from Germany to the Netherlands and then back to England, earning degrees in business and law, and climbing mountains in his spare time.

These days, Pyott continues to execute his master plan to keep Allergan growing pretty. In addition to pouring Botox profits into uncovering new treatments for the drug, Allergan is researching potential treatments for glaucoma, psoriasis, acne, and diabetes. Pyott's goal is to keep the company growing without going too far from what Allergan does best. "I'm a destroyer captain, not a battleship captain," he says. "Battleships are big and very slow. We're small, but we survive." Indeed, Pyott's deft handling of Botox may continue to help this decade-old company retain its youthful vigor.

—By Arlene Weintraub in Irvine, Calif.

Botox is being tested for migraines, back pain—even bladder problems

COMING UP ROSES

David Pyott

Suddenly, Botox is a household word

BORN Oct. 13, 1953, in London

EDUCATION M.A. in European law and German, University of Edinburgh, 1975; Diploma in European and international trade law, University of Amsterdam, 1976; MBA, London Business School, 1980

CURRENT POSITION Chairman, president, and CEO of Allergan, the maker of wrinkle-removing Botox

BONA FIDES Worked for 21 years at Swiss pharmaceutical giant Sandoz, now part of Novartis. Appointed CEO of Allergan in 1998.

CLAIM TO FAME Transformed Botox, an obscure treatment for rare muscular diseases, into a cultural and medical phenomenon. The word



Botox is included in the latest edition of the *Oxford English Dictionary*. Sales of the drug should reach \$540 million this year.

LITTLE-KNOWN FACT Pyott not only speaks French, German, and Spanish fluently but also learned the Indian language Maharathi while living on a sugar plantation near Bombay that his father managed.

STRESS BUSTER Tending roses at his home in Irvine, Calif.

FAMILY Married to second wife, Julianna; four children.



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A Closer Look at All Those Write-offs

Once rare, they're now all too common. Here's how to weigh their hit to the bottom line. **BY ANNE TERGESEN**

CORPORATE EARNINGS ARE FINALLY on the rebound, and investors are celebrating. But here's a sobering trend: Companies continue to announce earnings write-offs, often viewed as an admission that past results were overblown, at a rate that's far above the norm for previous economic recoveries. In fact, the current wave of write-offs—the largest in history, at \$400 billion in 2001 and 2002—has helped create “the worst quality of earnings in more than a decade,” says David Bianco, an accounting analyst at UBS. The trend is likely to continue. Although UBS expects the dollar volume of write-offs to decline this year as the economy brightens, “on average, the frequency and amount of one-time charges has been increasing,” Bianco says. In short, write-offs, which used to be infrequent, are now far too common. As a result, you can't analyze a company's income statements without parsing these special charges for restructur-

ing operations and marking down the value of assets on the books. That's why this installment of *The Fine Print*, an occasional series examining financial statements and other corporate disclosures, is devoted to showing you how to find these charges and weigh their impact on the bottom line.

Recurring write-offs can make it difficult to decipher a company's true performance. Consider International Paper, a Stamford (Conn.) company that has taken a charge against earnings in each of the past six years. And the tab—\$5 billion pretax—keeps rising, according to Levenson, director of research at independent bond researcher Gimme Credit. This year, the paper giant announced an additional \$100 million in restructuring charges, with more likely to come, Levenson predicts. The write-offs, she says in her recent report, make it “nearly impossible to get a handle on International Paper's normalized earnings.” That, of course, makes it difficult to value the stock.



Bullish on the Japan
stock market**134** Hunting down
the transfats**138** Discount airlines'
frequent fliers**144** Barker: Valuing
the Big Board

lion in fiscal 2000, \$872 million in 2001, and \$229 million in 2002.

Not surprisingly, Avaya has earmarked most of the money for layoffs and lease terminations. Of 2002's \$229 million charge, for example, the company allocated \$116 million for layoffs and \$84 million for leases it no longer needs (table). Avaya also reduced the value of assets on its balance sheet by \$7 million. Why? Current values are now below those on the books.

Although charges for such "asset impairments"—the term in the financial reports—require no cash outlays, they are troubling, since they're an acknowledgment that the asset won't generate as much future profit as expected, says Charles Mulford, an accounting professor at Georgia Institute of Technology. In 2000 and 2001, Avaya took asset-impairment charges of \$95 million, according to the expanded version of the table in the footnotes.

TOO FUZZY

IN 2002, AVAYA BENEFITED from a \$20 million reversal. When companies—either intentionally or accidentally—set aside more than is necessary to complete restructuring programs, they are required to "reverse" the excess by releasing it into earnings. The bulk of the \$20 million reversal—\$13 million—resulted from "fewer employee separations than originally anticipated," Avaya explains.

Although generally small, reversals can make a difference. In the fourth quarter of 2001, a \$35 million reversal added an estimated 7¢ to Avaya's earnings-per-share. In the second quarter of 2003, the company re-

A PIECE OF THE PUZZLE

Avaya's "restructuring reserve and related expenses" for 2002

cent Technologies in 2000, the Basking Ridge (N.J.) company has disclosed three types of charges on its income statement. By far the biggest: "business restructuring charges and related expenses."

For more information, flip to the footnotes. There, Avaya itemizes these charges in a table. The totals: \$684 mil-

Business Restructuring Reserve					Other Related Expenses		Total Business Restructuring Reserve and Related Expenses						
Employee Separation Costs	Lease Termination Obligations	Other Exit Costs	Total Business Restructuring Reserve	Asset Impairments	Incremental Period Costs								
(dollars in millions)													
\$	116	\$	84	\$	1	\$	201	\$	7	\$	21	\$	229
	(13)		(4)		(3)		(20)		—		—		(20)
	(3)		—		—		(3)		—		—		(3)
	(128)		(56)		(3)		(187)		—		(21)		(208)
	—		—		—		—		(7)		—		(7)
\$	68	\$	102	\$	—	\$	170	\$	—	\$	—	\$	170

person for the company responds the restructuring has improved "our business and made us a stronger entity."

first place to look for write-offs is some statement. There, companies voluntarily segregate charges from expenses. Why? To encourage in-

to look upon is different than operating expenses—such as "selling, general, and administrative" costs treat them as a one problem.

It's how telecommunications-equipment-maker Avaya treats charges in the income statement found in its 10-K. Since it spun off from Lu-

versed \$17 million, adding 4¢ to the bottom line. Since profits from reversals have nothing to do with a company's operations, Mulford advises investors to ignore them.

The table also discloses how much progress Avaya has made in completing its restructuring plans. This is important because the Securities & Exchange Commission encourages companies to finish restructurings within a year of their announcement, says Dennis Beresford, accounting professor at the University of Georgia. Because charges

are estimates, one way to improve their accuracy—and cut down on reversals—is for companies to calculate the cost of maneuvers such as plant closings just before they occur, says Beresford.

SMART FORMULA

SOME OF AVAYA'S restructuring reserves have been outstanding for longer than a year. For instance, at the end of fiscal 2002, the table lists a \$170 million balance—hence, a \$170 million “business restructuring reserve” on the liability side of the balance sheet. As of June, the balance was down to \$81 million. A company spokesperson says although the company implemented its plans within a year, some obligations have taken longer to pay down.

To make sure you haven't missed anything, scan the footnotes beyond the table. In 2002, Avaya reveals a \$17 million charge for soured investments in other communications companies. That's deducted from “other income” on the income statement.

To assess the impact of write-offs on the bottom line, you should treat recurring charges as a normal cost of doing business, just as you would salaries or overhead. UBS' Bianco calculates the average annual cost of write-offs over several years—10, if possible. Then, he subtracts that average from the bottom line, ignoring the actual charges. The result: a version of the bottom line that takes write-offs into account without the boom-and-bust volatility you would get by looking at the printed numbers. In an era in which “special” charges are, unfortunately, anything but special, it pays to do the math. ■

To be a savvy investor take the time to do the math

Why Japan Looks Good Again

An investment pro talks about recovery, carmakers and where hot opportunities lie.

FEW FUND MANAGERS have experienced the gut-wrenching spins of the Japanese stock market like **Shuhei Abe**. He founded Sparx Asset Management—now managing \$3.7 billion—back in 1989 as stocks hit all-time highs. Then he watched the market's death spiral. Even with this year's 27% gain (in local currency), the Nikkei is down 70% from its frothy peak. Tokyo Bureau Chief Brian Bremner recently spoke with Abe to find out why he's so bullish on Japan.

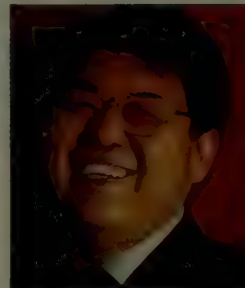
What's behind the 35% rally in the Nikkei since late April?

We should first take a look at the decline before then and the policies of the [Prime Minister Junichiro] Koizumi Administration that were implemented in April, 2002.

He employed two basic principles: One is fiscal discipline. Second, he advocated bank restructuring. Koizumi said that by 2004, the banks' equity portfolio should be lower than their core capital. So banks engaged in a kind of forced liquidation. What happened, though, is that [equity prices] became reasonable. Undervalued market conditions were created.

With banks no longer majority shareholders at many companies, how will corporate governance change?

Companies are changing. Now, Corporate Japan isn't owned by banks. Until the mid-1990s, over 50% of the equities of Corporate Japan were owned by banks through the cross-holdings networks. It is now only one-quarter. Now, shareholders such as pension funds and individual owners [who] care about corporate performance [have a larger voice].



Is Corporate Japan delivering on profits?

The last peak [year] of its was 1989. And the estimated earnings growth for fiscal 2004 is 65% what the rate of earnings growth was in 1989. Profits are increasing, yet the market is still 70% lower

the 1989 peak. [Profit growth] coming from an increase in sales from cost restructuring.

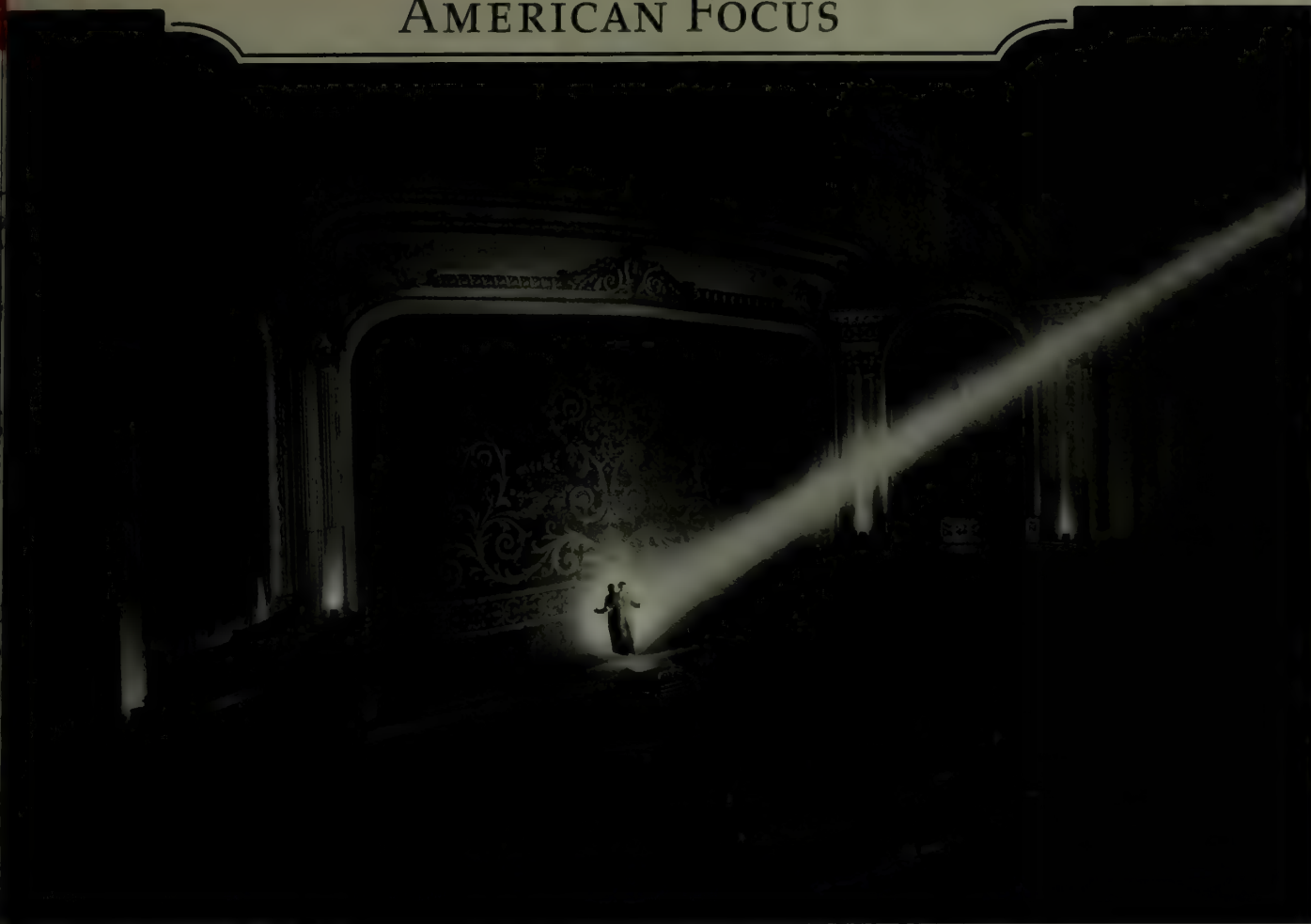
What sectors do you like?

I'm quite encouraged by the banking sector. The nonperforming-loan problem peaked in 1998 and has since been declining. The banks have been employing stricter measures to classify loans. I expect them to meet their expected numbers in September [half-year fiscal year results]. The world will start to be impressed.

Top Japanese auto makers are on a tear. Why?

The Japanese auto sector is entering a new phase of growth. What is happening today is that Japanese auto makers are growing rapidly outside of Japan, and increasing their market share. Toyota Motor is [the leading] beneficiary, far, and though Nissan Motor is starting from a smaller base, its strategy is interesting. ■

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The Fine Art of Finding the Fat

Trans-fats won't be listed on all food items till 2006. Here's how to spot them now. **BY ANNE TERGESEN**

YOU THINK YOU'RE eating a healthful diet because you've limited your consumption of artery-clogging saturated fat. But if you are not minding your intake of another harmful fat called trans-fat, you might still be increasing your risk of heart disease. Indeed, whereas saturated fat raises the body's level of bad "LDL" cholesterol, trans-fat packs a double whammy by also reducing the good "HDL" cholesterol that protects against heart disease, according to Penny

Kris-Etherton, professor of nutrition at Pennsylvania State University.

Many nutritionists say the most effective way to reduce this risk is by limiting the two "bad" fats combined to 10% or less of your daily calories. For a 2,000-calorie diet, that's less than 20 grams of saturated and trans-fat. Trouble is, while food labels are required to break out the saturated fat content, most are silent when it comes to trans-fat. And they can keep mum until Jan. 1, 2006, when a new Food & Drug Administration disclosure requirement kicks in.

In the meantime, if you want to avoid trans-fat, you can purge your pantry of

the known offenders. To identify the obvious ones, you'll need to do a bit of tritonal sleuthing.

Trace amounts of trans-fat occur in beef, cheese, butter, and milk. But the culprits are commercially prepared and baked goods, such as french chicken nuggets, doughnuts, crackers, and pies. Margarine is a big source, although it's lower in saturated fat than butter. Trans-fat can also pop up in unexpected places, such as in products that are relatively low in fat (table). For example: Kellogg's Nutri-Grain's berry cereal bars, which contain grams of trans-fat.

LONGER SHELF LIFE

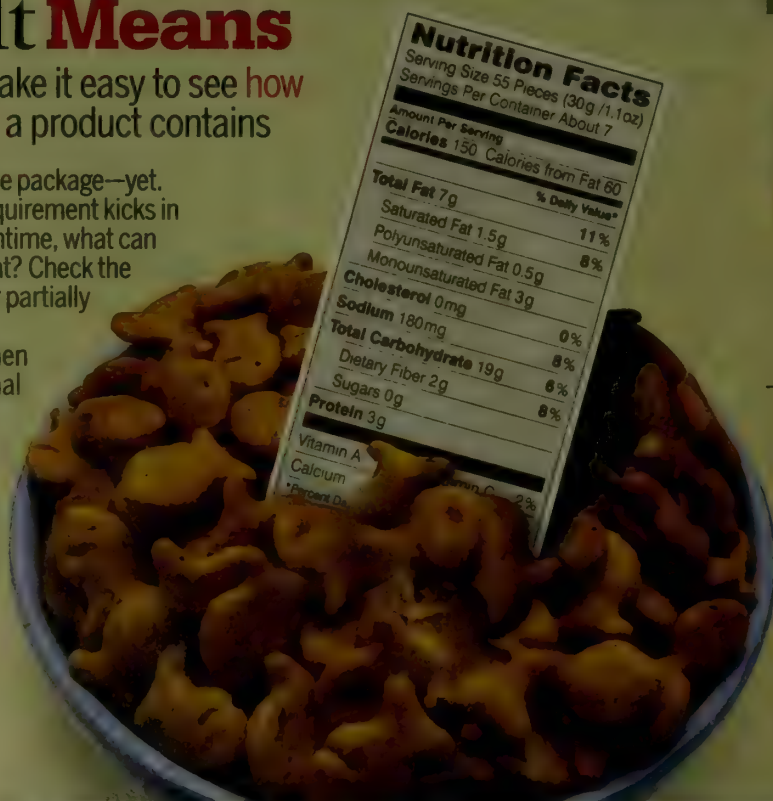
TO DETECT TRANS-FAT, start with the fine print on the label. If you see partially hydrogenated or hydrogenated in the ingredients, it's a good bet the product contains trans-fat, says Eric F. Flegal, associate professor of epidemiology and nutrition at Harvard School of Public Health. Trans-fat is made when manufacturers add hydrogen to vegetable oil. This enhances flakiness and shelf life, while also making it cheaper to produce, says Dr. Wootan, director of nutrition policy at Washington's nonprofit Center for Public Interest.

Exactly how much trans-fat a product contains is impossible to determine

What It Means

Labels don't make it easy to see **how much trans-fat** a product contains

Trans-fat is not on the package—yet. A new disclosure requirement kicks in in 2006. In the meantime, what can tip you off to trans-fat? Check the list of ingredients for partially hydrogenated or hydrogenated oil. Then look at the nutritional table (right); add the saturated, polyunsaturated, and mono-unsaturated fat, and you get 5 grams. Compare that with the 7 grams of total fat. The missing 2 grams? At least half of it is trans-fat.



HYDROGENATED OIL?

Small Amounts*



Contains 0.5 grams of trans-fat

None



Zero fat grams on label and no hydrogenation



Contains less than 0.5 grams of trans-fat

* per serving



Fat-free with no hydrogenated oil shortening

"NO ONE UNDER 17 ADMITTED WITHOUT PARENT OR CARDIGAN."



**Even the smallest error in communication can lead to confusion.
Odds are, it's affecting your revenue in a big way.**

Producing and delivering business communications seems simple enough. Why, then, do so many companies so often send bills to the wrong people; mail important packages with too little postage; and lose digital documents in cyberspace? It all adds up to a logjam that prevents revenue from reaching your bottom line.

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Pitney Bowes

Engineering the flow of communication

get a rough idea, look at the order of ingredients. The closer hydrogenated oil is to the top, the more trans-fat is likely present, Rimm says.

You can obtain a more precise reading if a label goes beyond what's required and breaks down total fat into several components. For example, look at Pepperidge Farm's pizza-flavored Goldfish crackers. Eat one serving, or 55 tiny crackers, and you'll consume 7 grams of total fat. That includes 1.5 grams of saturated fat and

3.5 grams of the more benign polyunsaturated and monounsaturated fats. Total that up, and you get 5 grams—or 2 grams shy of the 7 listed under "total fat." What happened to the remaining 2 grams? Since the product contains partially hydrogenated vegetable shortening, trans-fat is a suspect.

ROUNDING TO ZERO

SUCH RECKONING IS far from perfect. The government allows food companies to

round fat content to the nearest half. Foods with less than 0.5 grams of fat round down to zero. So rounding may count for some of the Goldfish crackers, missing 2 grams of fat. A spokesperson for Pepperidge Farm puts the trans-fat content at between 1 gram and 1.5 grams per serving. The company is evaluating ways to reduce or eliminate trans-fat.

Still, until companies remove trans-fat or give it a place on the label in 2006, approximations are the best you can

Travel

A Shot of Swank For Atlantic City

A new casino, the Borgata, hopes to bring in the high rollers. **BY CHRISTOPHER PALMERI**

THE BORGATA CASINO Hotel & Spa, a \$1.1 billion joint venture between MGM Mirage and Boyd Gaming, brings beautiful design, fine dining, and high-end shopping to Atlantic City. But will it attract a more upscale clientele—"Atlantic City rejecters" is the term Borgata executives use—rather than the day-tripping slot players who make up a large part of the seaside town's visitors?

For starters, the Borgata's decor is striking. The entry is a multistory wall of frosted glass. Red and purple lights illuminate the front desk. Dale Chihuly's garish glass chandeliers hang from the ceiling.

This is a softer and quieter place to gamble. The casino feels spacious and airy, with wide aisles and a marble path that lets you navigate the floor with ease. A glass-walled "Living Room" separates the hotel elevators from the casino floor, providing a place to relax but still take in the action nearby. The spa has a separate hair salon for men, modeled after an old barber shop and featuring a pool table. When it's time to leave, you pick up your

car from an underground valet apart from the main entrance, so you don't get stuck with the incoming traffic.

When you get hungry, be prepared to pay up. The \$16.95 buffet lunch, served in the Borgata Buffet, is laid out on stainless steel platters, not the usual warming trays, and is a step up in presentation and quality. On the Monday afternoon we were there, just four of the Borgata's 11 restaurants were open for lunch, and that was not enough. There was even a line to get into the tequila bar. That meant we didn't get to sample the higher-end entries, like Suilan, an Asian fusion restaurant from Susanna Foo, a well-known Philadelphia chef, or the Old Homestead, an offshoot of the Manhattan steakhouse whose menu includes a \$41 Kobe beef burger.

The Borgata has been following its Atlantic City rivals in booking top-shelf entertainment in two auditoriums that seat 1,000 and 2,400, respectively. Comedian Bill Cosby and singer

SPACIOUS
You can
navigate the
floor with
ease.



Jewel were two recent performers. But Borgata's retail shops were a disappointment both in number and merchandise. Who needs another store selling Dockers shirts and Tommy Bahama khaki shorts?

The guest rooms, which start at \$100 a night (for weeknights), feature 300-thread-count bed linens, high-speed Internet access, showers for two, and floor-to-ceiling windows for panoramic water views. True, the Marina District location, a 15-minute jitney ride from the city's famous boardwalk, leaves you feeling a bit isolated. But Atlantic City's new casino revealed a different side of the town.

The Borgata's first month of operation it looks as if the joint in town is bringing new faces—some big ones—among them. ■



n. The addition of business customer number 360,001 creates a crisis for the Wall of Appreciation.

The image shows a woman from behind, looking at a large wall covered in many small, framed portraits. She is holding a small portrait of a man in her hand. In the foreground, there is a large advertisement for CDW. The advertisement has a red header with the CDW logo and the text "The Right Technology. Right Away." Below this, it says "More objective advice from experts who know about the technology products they offer. It's why more business customers trust the same Fortune® 500 company. CDW." At the bottom of the ad, it says "CDW.com" and "800.780.4CDW".

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Fliers' Dilemma: Save Now or Later?

Tickets on discount airlines cost less, but their frequent-flier programs make it tough to earn a freebie. **BY MICHAEL ARNDT**

JETBLUE AIRWAYS GIVES travelers plenty of reasons to choose it over its giant rivals: new planes, comfy leather seats, 24 channels of live TV, bargain fares. Its frequent-flier program, however, isn't one of them. Unless you take 13 medium-

length or five long-distance round-trips within a year, you'll never qualify for a free ticket. Even if you do, you can forget about cashing in your points for a foreign getaway, since JetBlue doesn't fly outside the U.S.

The frequent-flier plans at other low-fare carriers aren't much better. Indeed, this is one area where the major airlines beat

the discounters down. While their programs require flights for free thanks to their long partners, you can rack up miles much quicker use them to fly anywhere. You also have to worry about points expiring. "I see any low-cost program that is competitive," says Randy son, editor of Inside

the discounters down. While their programs require flights for free thanks to their long partners, you can rack up miles much quicker use them to fly anywhere. You also have to worry about points expiring. "I see any low-cost program that is competitive," says Randy son, editor of Inside

POPULAR PERK

THE FREQUENT-Flier concept dates to when American Airlines launched the first program. United Airlines followed with identical plans, awarding travelers points for every mile they fly. But for Southwest Airlines, the discounters stayed out of the game. Over the few years, though, more business travelers have turned to low-carriers, they, too, added frequent-flier programs. Today, except Spirit Airlines and Country Airlines, the discounters have one. Most of the low-fare

The Other **Frequent-Flier** Programs

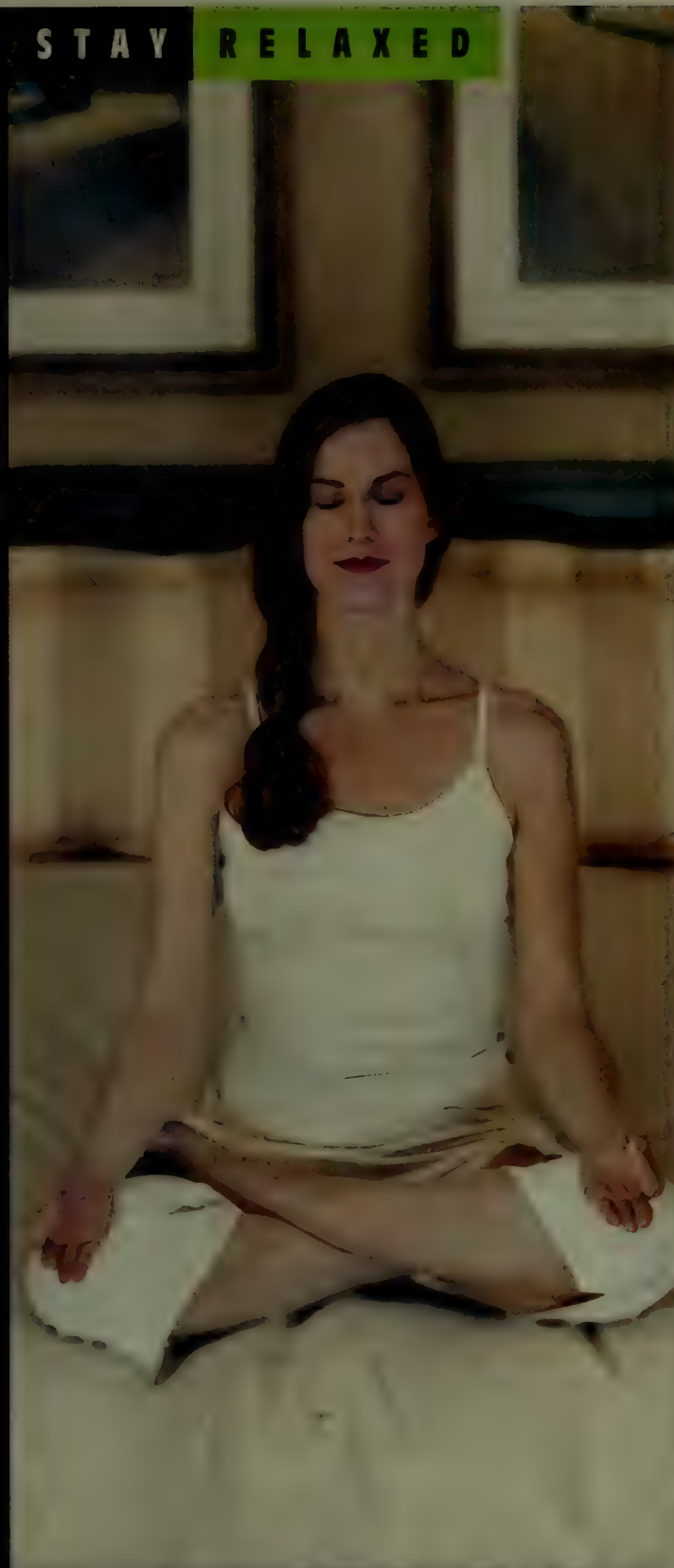
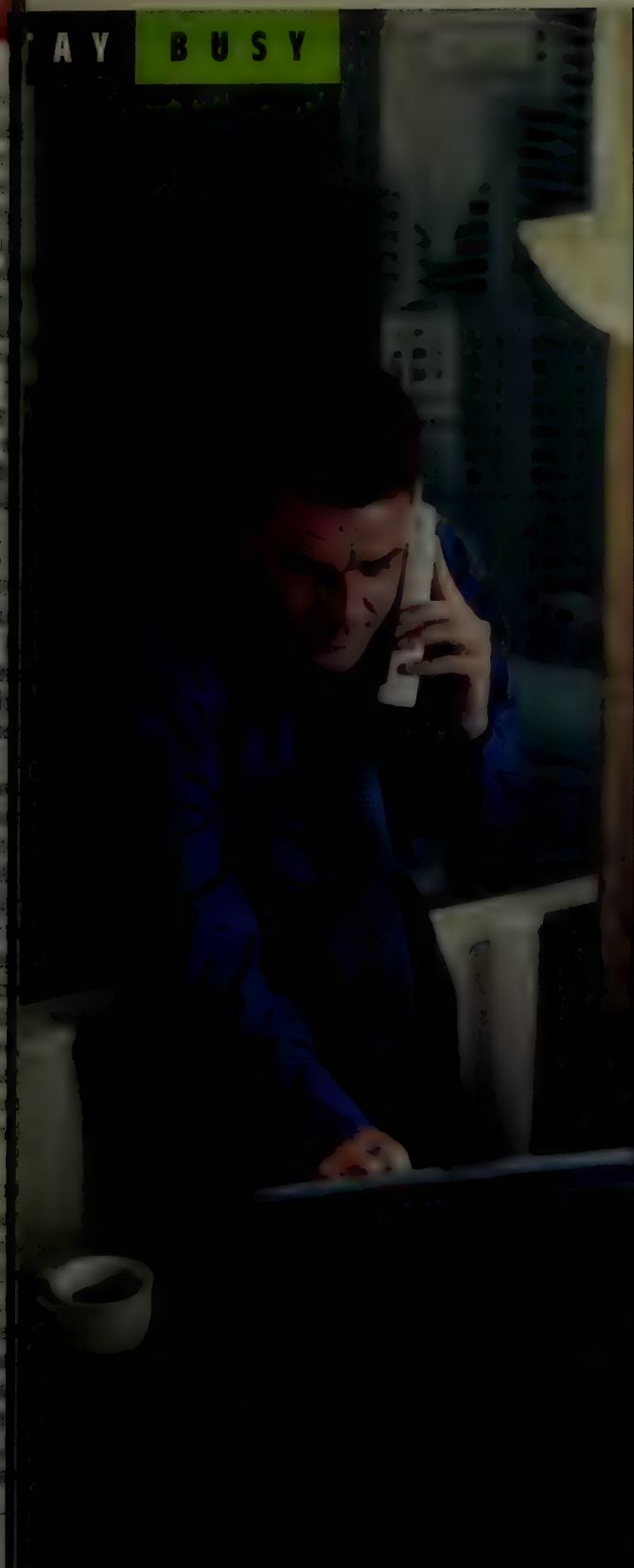
AIRLINE	AIRTRAN	ATA	FRONTIER	JETBLUE	SOUTHWEST
FREE-TICKET REQUIREMENT	8 round-trips in 12 mos.	6 round-trips before Jan. 31, 2005	15,000 miles or 6 cross-country round-trips	13 medium or 5 long round-trips in 12 mos.	4 round-trips in 12 mos. if booked online
SEAT UPGRADES?	Yes	No	No	No	No
AIRLINE PARTNERS	Yes**	No	Virgin Atlantic, Midwest	No	No
OTHER PARTNERS*	1	No	10	No	15
COMMENTS	Upgrades to business class a selling point	No partners makes it hard to earn free travel	Points never expire; you can fly to Europe	Points often expire before a freebie is due	Best for frequent short-hop fliers

*Credit-card, hotel, or rental-car companies

**Can transfer points to partners only after logging 16 round-trips with

AY BUSY

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STAY YOUR OWN WAY™

that rate, he's earning a free back-and-forth almost every four months. "This seems like the quickest way to redeemable points," he says.

But flier beware: On Southwest, JetBlue, and AirTran Airways, points expire a year after every flight. That means that many travelers never get a chance to accumulate enough points to go anywhere for free. Contrast that with the programs at the major airlines, which permit you to keep all of your miles as long as you earn at least one point within three years. Moreover, in

Upgrades aren't an option when there's only one class

the off-price segment, only AirTran offers business-class service, so you can't generally use your points for upgrades, either.

That's not all. At JetBlue and ATA, the only way to build up points is by buying airline tickets. By comparison, American

boasts 1,300 partners that award points for its frequent-flier program, including other airlines, hotels, car-rental outfits, credit-card companies, mortgage banks, and even Kellogg, which prints 100-point coupons on its cereal boxes.

SOMETHING FOR EVERYONE

THE LACK OF POINT partners at the discount carriers diminishes the value of their programs in another way. Except at Frontier Airlines, which has a tie-in with Virgin Atlantic Airways, frequent-flier members cannot readily use points to fly on other airlines. "I don't think people are flying JetBlue for the points," concedes Timothy Claydon, JetBlue's senior vice-president for sales and distribution.

Of course, the drawbacks haven't stopped discount carriers from gaining market share or making money. So will the major airlines copy them by paring back their plans? No way. They know their frequent-flier programs still attract a lot of traffic. "[Customers] prefer our model," says Gloria Berndt, United's director of marketing programs. "Frequent fliers say: 'I've had my butt in a seat for a long time, and I want to be rewarded,'" she adds. So travelers, take your pick: cheap fares or free tickets. You can have either, but you can't have both. ■

Paddle, Anyone?

Played on smaller courts, platform tennis keeps the hardy active in winter. **BY MARILYN HARRIS**

THE NIGHT AIR WAS BEYOND BITTER, the wind cut like a buzz saw. Light flooded a metal platform enclosed by chicken wire, on which four figures, bundled in fleece, chased a yellow ball and smashed it across the net. A car screeched up, and out jumped a man. "She has been crying since you left!" he shouted. His wife dropped her graphite paddle with a clang, raced into the car, and as soon as she could peel away the layers, was

like to defy the weather, the court better. The court measures 44 by 22 feet and resembles a miniature tennis court made of aluminum and coated with sandpaper-like finish, for traction.

Paddle is so easy to learn that tournaments run by the American Platform Tennis Assn. (platformtennis.org) feature players as young as 8. The equipment is minimal. A paddle, about 18 inches long and made of a composite material with aerodynamic holes in the head, costs roughly \$100.

Balls—solid rubber and sized like tennis balls—cost about \$10. The only special gear you may need is a fleece mitt that fits over your hand and paddle handle. When the weather is frigid, the rules, they're essentially the same as in tennis, except paddle has only one serve, and serve faults and touch the net are played. You also hit the ball off the wire, similar to what you do in tennis.

The major challenge for newcomers is finding a place to play. Most of the 4,000 or so courts in the U.S. are at private clubs and resorts, including Snow King Resort in Jackson Hole, Wyo., and Shelter Inn in Westerly, R.I. Some courts are available, mostly in the metro New York and C. and parts of California, Colorado, and Wisconsin. And new communities are increasingly building courts to attract

Paddle is largely a doubles game, marked by rapid volleying at the net. "There's no better way to get some exercise on a cold winter's day," says New York banker Roger Bredder. "It's fast-paced action, great competition, and it keeps you in shape without having to drive to a ski resort. Plus you can play in a bubble." Hey, who couldn't use a sport that makes it fun to be out in nasty weather? ■



nursing her infant daughter. A short while later, play resumed.

What would make a mom run out on her newborn? "Neither rain, nor snow, nor crying babies keep me away from platform tennis," says the athletic mother of three. Male or female, old or young, if you're hooked, you're hooked. "It's like a cult sport," says Patty Hogan, the over-40 national women's champion and a teaching pro based in Summit, N.J. "Anybody who plays it, loves it."

The season for platform tennis—called paddle, for short—is coming up fast. By tradition, the game is played in fall and winter, and for aficionados who

FAST PACE

Much of the action consists of rapid volleying at the net

They both took care of
business.

Took care of their
families.

So why will one

leave his family with every
advantage,

while the other leaves

everything to chance?



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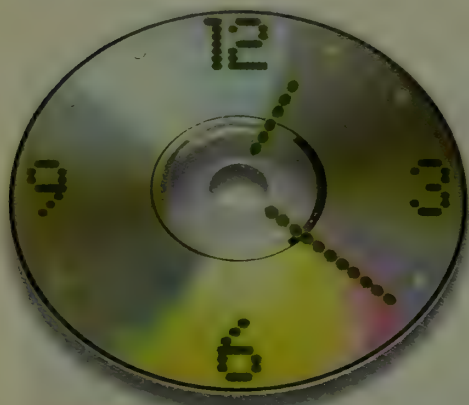
Innovative solutions for retirement, estate, insurance, and personal finance. **Are you there yet?®**

EDITED BY TODDI GUTNER

HEALTH

WHERE TO ARM YOURSELF AGAINST THE FLU

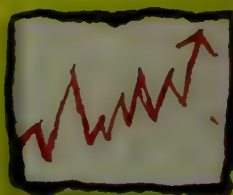
SOME 140,000 Americans are hospitalized each year with the flu. One way to avoid that fate is to get a flu shot during October or November. Vaccinations are 75% effective in preventing the flu and reducing its severity. To find a pharmacy or grocery store that gives shots near you, go to findaflushot.com. You can search by Zip Code, area code, or state, and indicate how far you want to travel. Each shot costs \$20 and covers three strains of the virus.



VIDEO

AND NOW, DISPOSABLE DVDs

EZ-D DVDs have the same sound and picture quality as conventional DVDs but without extras such as commentary. Oh, and another thing: **They self-destruct in 48 hours.** The disposable disks just became available in Austin, Tex., Charleston, S.C., Kansas City, Mo., and Bloomington/Peoria, Ill. Buy one for about \$5 (the price of a rental), play it as much as you want for 48 hours, then send the disk to a recycling facility or throw it away. If you don't open the package, it has a shelf life of one year.



STOCKS

The Options Hit

THOSE OF US WHO want to believe nice guys finish first are getting a kick in the pants courtesy of this year's stock market. Economists at **Morgan Stanley** recently wondered whether companies that have done the right thing and begun charging the cost of their employee stock options against current earnings have been rewarded by stock market returns. The unequivocal answer? Nope.

This year through mid-September, the 76 companies in the **Standard & Poor's 500** stock index that do expense options saw their share prices rise 15.9%. Those that didn't? Up 25.3%. The most honest defense for companies unwilling to deduct options expenses, Morgan Stanley concludes, "is that if analysts start recognizing options as a cost, earnings estimates will decline and [stock prices] will fall." Accounting authorities recently postponed rules mandating expensing of options, a depressing, if perhaps pragmatic, signal to stay bullish on stocks. —By Robert

WAGES

IF YOU'RE HAVING a Big Mac attack, where you live determines how long you have to work to buy the McDonald's burger. **In Nairobi, it takes three hours to afford one;** in Chicago, L.A., or Tokyo, just 10 minutes will do it. The time required in other cities falls in between, says a UBS study.



WORKING TIME TO BUY ONE BIG MAC

CITY	MINUTES
NAIROBI	180
KIEV	80
BANGKOK	50
TEL AVIV	30
ISTANBUL	30
LONDON	10
HONG KONG	10
NEW YORK	10
TOKYO	10

*Methodology: Product price divided by weighted average net hourly pay across 12 occupations



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BY ROBERT BARKER

A Gold Mine Called The Big Board?

Sooner rather than later, most people will find the name Dick Grasso hard to place, and the New York Stock Exchange will shake off the mud that covers it today. Then, somewhere in this dreary process called "moving on," the prospect that the Big Board itself is going public will glow.

As alluring as an initial public offering of stock may prove to 1,366 NYSE seat holders—the exchange's actual owners—arranging the deal would not be simple. Even a ticker symbol is tricky. The four letters NYSE almost surely wouldn't do, since the world's leading stock exchange has prided itself on issuing common stock symbols no more than three letters long. (Note to Santiago, Chile's BBV Banco BHIF, holder of the Big Board's BB symbol: Stay flexible.) Just the same, as an investment the NYSE is a potential gold mine—even if it hasn't paid lately.

You can get a glimpse of this from the NYSE's financials. The most recent set is for the year ended last Dec. 31. As a not-for-profit, the NYSE doesn't release the full quarterly details required of public companies. Instead, it gives just a few interim figures: Through June 30, revenue ran flat at \$539.5 million, while net income rose to \$27 million from \$20.7 million. That improvement had to be welcomed warmly. Since 1998, the Big Board's operating margin got crushed, coming in last year at 4% on a bit more than \$1 billion in revenue (charts).

THIS, PERHAPS EVEN more than the investing public's post-bubble hangover, accounts for the 30% plunge in value of a stock exchange seat. The highest price for a seat, \$2.65 million, was paid in 1999; the most recent price, on Sept. 18, was \$1.85

million. If each of the exchange's 1,366 seats could be that, the total would come to \$2.5 billion. But this in captures the Big Board's potential public market value.

Consider events 500 miles west-northwest of Wall Street. Just before the Toronto Stock Exchange converted to a profit-making company, in April, 2000, its 133 seats traded near \$37,000 each, indicating a total value then of less than \$5 million. Last November the exchange's parent, TSX Group, went public and soon had a market value of a bit under \$500 million. Today, TSX's market cap tops \$800 million. Last December the Chicago Mercantile Exchange followed suit. The stock has doubled, giving the Mercantile a value of \$2.2 billion.

If it goes public, the Big Board can count on an explosion of value, too. To do this, it needs first to change, as the Merc says it did, from an organization designed "to offer profit-making opportunities for our members and to limit our profits" to one focused on its own bottom line. In so doing, it might have to give up some or all of its regulatory duties, foregoing revenue that now makes up 12% of its

This likely doesn't account for much profit, notes Chris Ruggeri, a managing director at Standard & Poor's Corporate Value Consulting (like *BusinessWeek*, owned by The McGraw-Hill Companies). It is one of many question marks in imagining an NYSE valuation.

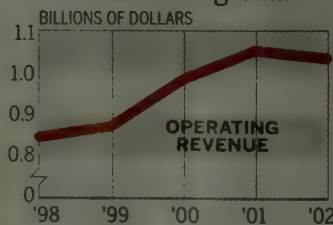
Suppose, just the same, the NYSE instantly managed itself toward the 35% or so operating margins enjoyed recently by publicly held firms. Then, it next year might show operating profits of, say, \$350 million. Other public exchanges tend to trade near 13 times operating income and roundly five times sales. At these multiples, the NYSE would have a market value of around \$5 billion, or about double the current value of its seats—enough to make the Big Board forget the name Dick Grasso.

E-mail: rb@businessweek.com



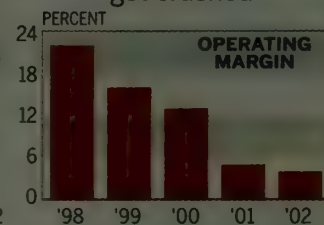
THE BIG SQUEEZE

Even as the NYSE's revenues grew...



Data: Company reports, *BusinessWeek*

...its profit margin got crushed



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BY GENE G. MARCIAL

WHY THERE ARE TAKEOVER WHISPERS AT INSURER W.R. BERKLEY FOR LANGUISHING LIBERTY MEDIA, MAYBE THE ONLY WAY IS UP SONTRA'S GLUCOSE MONITORING DEVICE: A BOON FOR DIABETICS

Berkley: A Good Risk

OUT AHEAD OF ITS PEERS is W. R. Berkley (BER): This mid-cap property-casualty insurer is a star performer—in sales, earnings, and stock price. In the second quarter, operating earnings rocketed 96% above last year, to \$95.8 million. The shares have shot from 20 last October to 35.16 on Oct. 1. “As a result, Berkley is an attractive takeover target in a long-overdue consolidation,” says Mike Frinquelli, a general partner at Renaissance Fund Advisors, which owns shares. Part of Berkley’s allure, he says, is robust cash flow—it has a stash of more than \$1 billion—and a focus on specialty markets, which lets Berkley raise its rates easily. Berkley goes where most insurers fear to tread, notes Frinquelli, such as policies for doctors who have malpractice woes or liability coverage for company directors, where rates have more than doubled with the escalation in Wall Street scandals. Alan House of Value Line sees sales growing 45% this year, after a 34% gain in 2002. CEO William Berkley, who owns 15% of the company, says “bigger profits are coming in the next two years.” Even though the company is “doing extremely well,” Berkley doubts that “anybody will offer a price that matches what I think it’s worth.” Frinquelli sees the stock hitting 50 in 6 to 12 months. In a buyout, it would be valued even higher, he says. Jay Cohen of Merrill Lynch, who rates Berkley a buy, figures it will earn \$3.20 a share in 2003 and \$3.73 in 2004, vs. \$2.03 for 2002. Merrill has done banking for Berkley.

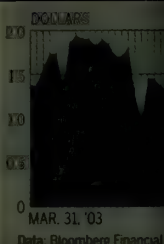


advantage of the drop to buy more shares: Hilary Kramer, president of A&G Capital, is betting that the stock is close to its bottom and should be climbing soon. “Not many realize that Liberty is way undervalued, based on the array of worldwide assets it owns or has a stake in.” It owns such channels as Discovery and Starz, and a slice of News Corp. also holds stakes in Time Warner and some Net outfits, as Barry Diller’s InterActiveCorp. Kramer puts the value of the assets at \$15 a share. Her 12-month target for the stock is 18. Niraj Gupta of Smith Barney, who owns shares, says Liberty, which trades at a 30% discount to its net asset value, is “attractive for long-term investors.” Smith Barney’s parent, Citigroup, has done banking for Liberty.

Sontra Medical Looks Healthier with Bayer

WITH GIANT Bayer as a partner, tiny Sontra Medical (SONTC) could make it big in the \$5 billion market for home glucose testing for diabetics. In July, Sontra granted Bayer rights to SonoPrep, its patented, noninvasive skin-permeation technology that allows 24-hour glucose monitoring through a sensor patch. Come January, Bayer will pay Sontra \$1.5 million for feasibility studies, to be followed later by a \$3 million payment to co-produce SonoPrep. If all goes well, Sontra will apply for Food & Drug Administration approval. Sontra CFO Sean Moran figures Bayer will then commit \$15 million to have the product ready for marketing in late 2004 or 2005. Joe Hammer of LH Financial, an investment firm, figures the initial market could hit \$150 million. He thinks the shares, which dropped from 5.60 last October to 81¢ in July on news of possible NASDAQ delisting, have bright prospects. They have since rebounded to 1.40. Sontra raised \$3 million from private investors in August to avoid delisting. Larry Salvati, director of applied research at Bayer, says Bayer is impressed with Sontra’s SonoPrep technology.

REVIVING AFTER A ROCKY SUMMER



Liberty Media: Set for a Rebound?

LIBERTY MEDIA (L), the flagship of cable-TV mogul John Malone’s empire, hasn’t done much in this year’s market rally, but some pros think it is poised for a strong rebound. The stock has been caught between 8 and 12. Recently, it dipped to 10, following Liberty’s \$7.8 billion purchase of the 57% of home-shopping network QVC that it didn’t already own. But some pros are taking



KRAMER “Climbing”

BusinessWeek online Gene Marcial’s Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. on the magazine’s publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNNfn’s Money Gang.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor the firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.



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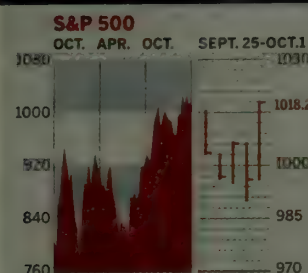
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Figures of the Week

STOCKS



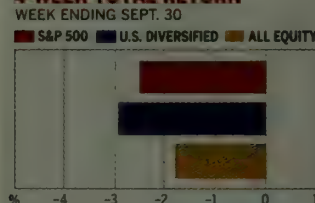
COMMENTARY

It was a rollercoaster ride as stocks fell most of the week before reversing direction and rallying broadly on Oct. 1. Signs of vigor in manufacturing helped spark the surge. More important, investors are focusing on upcoming profit reports, expected to be juicy. For the week, the Dow and the S&P 500 ended in the black, while the NASDAQ finished in the red.

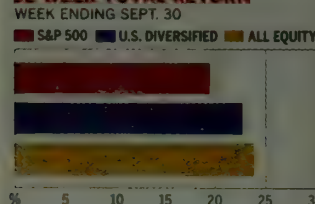
Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

U.S. MARKETS

	OCT 1	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1018.2	0.9	15.7	20.1
Dow Jones Industrials	9469.2	0.5	13.5	19.3
NASDAQ Composite	1832.3	-0.6	37.2	51.0
S&P MidCap 400	521.4	0.1	21.3	25.2
S&P SmallCap 600	242.1	-0.6	23.1	26.4
Wilshire 5000	9859.6	0.5	18.2	22.6

SECTORS

			% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	588.4	1.1	8.5	9.7
BW Info Tech 100**	324.6	0.7	13.7	30.7
S&P/BARRA Growth	519.2	0.8	15.7	18.7
S&P/BARRA Value	495.6	1.0	15.8	21.7
S&P Energy	199.5	0.6	8.9	10.4
S&P Financials	351.0	1.9	18.2	20.9
S&P REIT	108.5	1.5	19.3	18.2
S&P Transportation	180.6	0.3	5.3	6.1
S&P Utilities	111.9	2.3	14.4	16.0
GSTI Internet	134.1	-3.4	79.5	115.9
PSE Technology	620.1	-0.5	37.1	57.3

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	OCT 1	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	969.4*	-2.1	14.1
London (FT-SE 100)	4169.2	-1.6	5.8
Paris (CAC 40)	3191.0	-2.2	4.1
Frankfurt (DAX)	3329.8	0.7	15.1
Tokyo (NIKKEI 225)	10,361.2	-1.3	20.1
Hong Kong (Hang Seng)	11,229.9	-5.8	20.5
Toronto (S&P/TSX Composite)	7509.7	-1.2	13.5
Mexico City (IPC)	7937.2	1.9	29.5

FUNDAMENTALS

	SEPT. 30	WEEK AGO
S&P 500 Dividend Yield	1.57%	1.62%
S&P 500 P/E Ratio (Trailing 12 mos.)	27.6	28.9
S&P 500 P/E Ratio (Next 12 mos.)*	16.7	16.7
First Call Earnings Revision*	0.83%	0.61%

TECHNICAL INDICATORS

	SEPT. 30	WEEK AGO
S&P 500 200-day average	931.6	929.1
Stocks above 200-day average	80.0%	82.0%
Options: Put/call ratio	0.83	0.71
Insiders: Vickers NYSE Sell/buy ratio	5.00	5.11

BEST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Casinos	9.5	Photographic Products -25.0
Homebuilding	9.0	Semiconductor Equip. -12.4
Internet Software	8.9	Specdy. Appar. Retailers -11.4
Divsfd. Metals & Mining	8.2	Employment Services -9.3
Divsfd. Financial Svcs.	8.1	Tires & Rubber -8.4

WORST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Internet Software	275.0	Health-Care Facilities
Comptr. Stge. & Perphs.	122.6	Photographic Products
Wireless Services	120.7	Tires & Rubber
Divsfd. Metals & Mining	113.5	Housewares & Special
Office Electronics	106.8	Brewers

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Precious Metals	3.2	Technology	62.3
Real Estate	2.1	Latin America	49.1
Diversified Pacific/Asia	1.8	Communications	45.8
Europe	1.8	Precious Metals	42.7
LAGGARDS		LAGGARDS	
Technology	-4.3	Miscellaneous	13.0
Mid-cap Growth	-4.0	Domestic Hybrid	14.1
Small-cap Growth	-3.8	Large-cap Blend	17.3
Small-cap Blend	-3.3	Natural Resources	18.1

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
American Heritage	33.3	PFds. Intnet. Ultsr. Inv.	206.1
U.S. Gl. Wld. Pr. Minls.	9.7	Jacob Internet	198.0
Scudder Gl. & Pr. Mts. S	9.4	Apex Mid Cap Growth	150.9
Matthews Japan	8.5	RS Internet Age	136.7
LAGGARDS		LAGGARDS	
PFds. Ultra Japan Inv.	-13.2	Rydex Dynam. Vent. 100	-66.5
Grand Prix A	-12.6	PFds. Ultsr. OTC Inv.	-66.3
PFds. Smicdr. Ultsr. Inv.	-11.4	Frontier Equity	-60.3
Berkshire Focus	-10.1	Potomac OTC/Short Inv.	-40.7

INTEREST RATES

KEY RATES

	OCT 1	WEEK AGO
Money Market Funds	0.62%	0.61%
90-Day Treasury Bills	0.94	0.93
2-Year Treasury Notes	1.44	1.60
10-Year Treasury Notes	3.93	4.14
30-Year Treasury Bonds	4.89	5.03
30-Year Fixed Mortgage†	5.74	5.90

†BanksQu

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	WEEK AGO
General Obligations	3.67%
Taxable Equivalent	5.24
Insured Revenue Bonds	3.76
Taxable Equivalent	5.37

THE WEEK AHEAD

INSTALLMENT CREDIT Tuesday, Oct. 7, 3:00 p.m. EDT »

Consumers very likely tacked on an additional \$5.3 billion in debt during August. That's according to the median forecast of economists surveyed by MMS International. In July, consumers added \$6 billion of new borrowings.

EXPORT-IMPORT PRICES

Thursday, Oct. 9, 8:30 a.m. EDT » Export prices probably held steady in September,

following a small 0.1% decline in August. Import prices most likely climbed 0.3%, after a 0.2% increase in August. The recent call by the Group of Seven for more flexible exchange rates is expected to cause the U.S. dollar to weaken, which would make imports more expensive and exports relatively cheaper.

PRODUCER PRICE INDEX Friday, Oct. 10, 8:30 a.m. EDT » Producer prices are forecast to

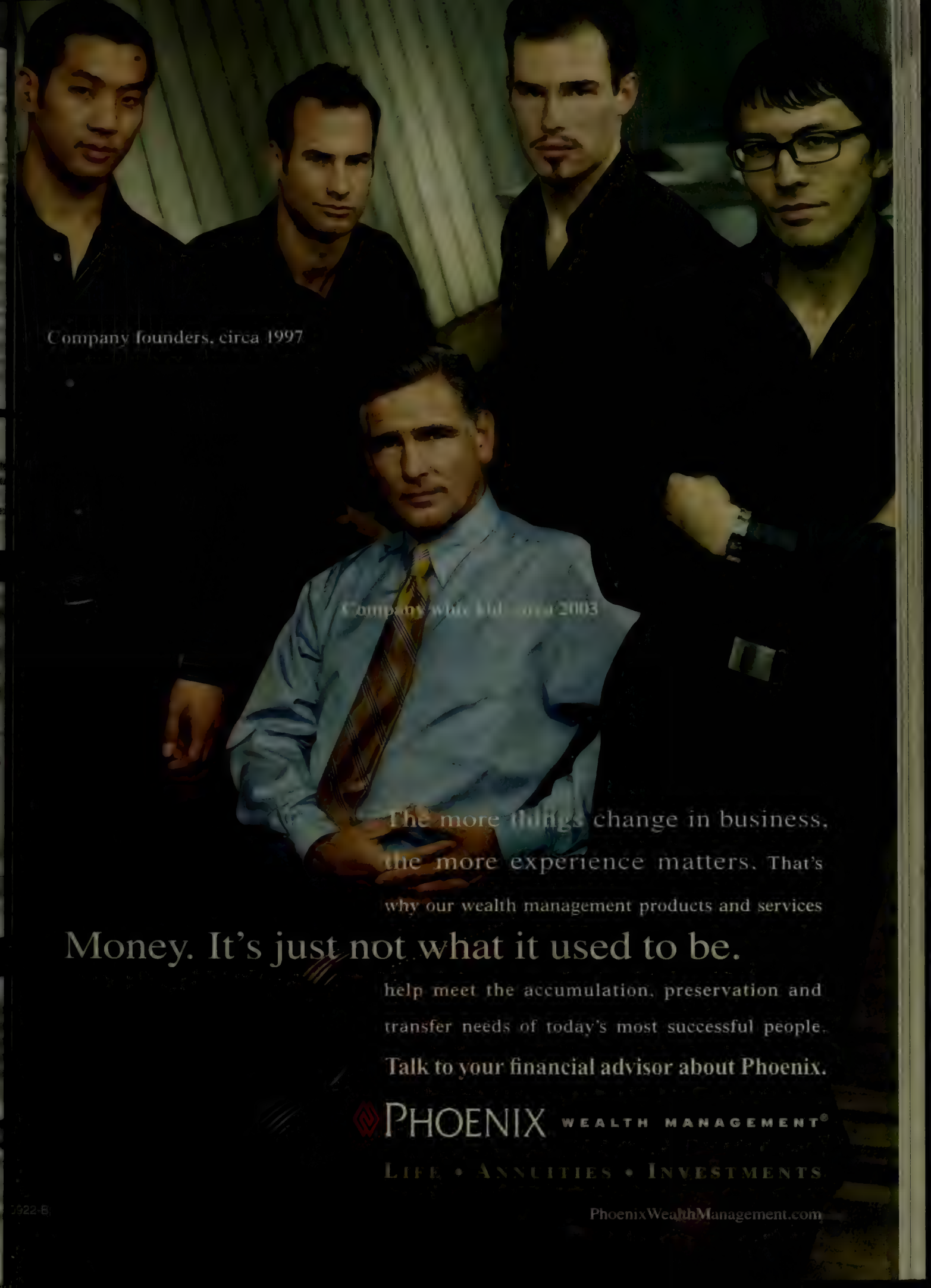
have grown 0.2% in September, after jumping 0.4% in August. Excluding the more volatile food and energy components, prices probably rose by a similar 0.2%, after a 0.1% increase.

INTERNATIONAL TRADE Friday, Oct. 10, 8:30 a.m. EDT » The foreign trade deficit very likely hit \$41 billion in August. Through July, the 2003 trade gap is \$56.5 billion ahead of 2002, which ended with a record \$435.7 billion deficit.

The BusinessWeek production increased to 201.2 for the week ended Sept. 20, up 5.6% from 190.9. Before calculation of the week moving average the slipped to 202.1.

BusinessWeek on

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/eq



Company founders, circa 1997

Company wealth club, circa 2003

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The Companies

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

A
A&G Capital **146**
Acacia Technologies (ACTG) **18**
Accenture (ACN) **56**
Axiom **49**
Adolph Coors (RKY) **82**
Adventis **42**
Aflac (AFL) **100**
Air France **60**
AirTran Airways (AAI) **138**
Allergan (AGN) **126**
Alliance Capital (AC) **46**
AllianceBernstein Technology Fund **46**
Allied Business Intelligence **90**
Amazon.com (AMZN) **42, 62, 70, 104**
American Airlines (AMR) **136**
American Management Systems **56**
America Online (TWX) **62, 114**
Amgen (AMGN) **100**
Antigenics (AGEN) **92**
Apple Computer (AAPL) **42, 46, 62**
AstraZeneca (AZN) **38**
ATA Airlines **138**
AT&T (T) **82**
AT&T Wireless (AWE) **24**
Avaya (AV) **130**

B
Banc of America (BAC) **94, 122**
Bank One (ONE) **122**
Bayer (BAY) **146**
Bear Stearns (BSC) **146**
BEA Systems (BEAS) **122**
Benchmark Capital **62**
Best Buy (BBY) **100**
Boeing (BA) **114, 152**
Boyd Gaming (BYD) **136**
Brean Murray **100**
British Airways (BAB) **60**
Broadview Associates **62**

C
Cardinal Health (CAH) **94**
CareerBuilder.com **62**
CIBC World Markets **16**

Cingular **24**
Circuit City Stores (CC) **100**
Cisco Systems (CSCO) **46, 104**
Citigroup (C) **115**
Cognetics **82**
Comcast (CMCSK) **62**
Conference Board **29**
Court Square Data **82**
Crédit Lyonnais **60**
Credit Suisse First Boston (CSR) **104**

D
DaimlerChrysler (DCX) **32**
Dealogic **104**
Dell (DELL) **32, 42, 152**
Deutsche Bank (DB) **104, 115**
Deutsche Morgan Grenfell **104**

E
eBay (EBAY) **62, 70**
eGreetings Network (EGRT) **104**
Electronic Arts (ERTS) **50, 100**
Electronic Data Systems (EDS) **56**
Eli Lilly (LLY) **46**
eMachines (EEEE) **104**
EMI Group **42**
Enron (ENRNQ) **26, 114**
Expedia (EXPE) **62, 70**

F
Fannie Mae (FNM) **115**
FleetBoston Financial (FBF) **117**
Ford (F) **32, 56**
Forrester Research (FORR) **62, 86**
Fossil (FOSL) **14**
Freddie Mac (FRE) **115**
Frontier Airlines **138**

G
General Electric (GE) **56, 62, 94, 152**
General Motors (GM) **32, 90**

Gimme Credit **130**
Goldman Sachs (GS) **104, 115**
Greenwich Associates **82**

H
Healthsouth (HLSH) **13, 46**
Hewlett-Packard (HPQ) **13, 94, 122**
Hilton (HLT) **62**
Hi-Tec Sport USA **86**
Holland **94**
Honda (HMC) **90**
Hotels.com (ROOM) **62**
Hotwire.com **62**
HSN (IACIZ) **62, 70**
Hyatt **62**
Hyatt Legal **46**
Hyundai Heavy Industries **58**

I
IBM (IBM) **46, 56, 86, 94, 122**
IDC **16**
ImClone Systems (IMCL) **92**
Intel (INTC) **122**
InterActiveCorp (IACIZ) **62, 70, 146**
InterContinental Hotels (IHG) **62**
International Paper (IP) **130**
Interwoven (IWOV) **104**
Intraware (ITRA) **104**
Intuit (INTU) **104**

J
Jefferies **13, 100**
JetBlue Airways (JBLU) **138**
Joel Popkin **82**
John Hancock Financial (JHF) **46**
Johnson & Johnson (JNJ) **100**
J.P. Morgan Chase (JPM) **46, 115**

K
Kellogg (K) **134, 138**
Kleiner Perkins Caufield & Byers **104**

KLM (KLM) **60**
Kotak Mahindra Capital **56**

L
Lehman Brothers (LEH) **50, 115**
LendingTree (V) **62**
LH Financial **146**
Liberty Media (L) **146**
Lockheed Martin (LMT) **114**
Lucent (LU) **130**
Lufthansa (DLAKY) **60**

M
Mandalay Resort Group (MBG) **62**
Manulife Financial (MFC) **46**
Marriott (MAR) **62**
Match.com **62**
Mattel (MAT) **100**
Maytag (MYG) **114**
McDonald's (MCD) **142**
McGraw-Hill (MHP) **144**
McLagan Partners **104**
Media General **18**
MediaSolutions **86**
Mercer Management **94**
Merck (MRK) **38**
Merrill Lynch (MER) **18, 50, 115, 117, 146**
Metropolitan West Financial **46**
MGM Mirage Resorts (MGG) **136**
Microsoft (MSFT) **14, 18, 42, 50, 56, 62**
MIPS Technologies (MIPS) **104**
Morgan Stanley (MWD) **60, 104, 115, 142**
MORI **55**
Motorola (MOT) **24, 32, 50, 90**
Musicmatch **42**

N
National Amusements **14**
NBC (GE) **62**
NEC (NIPNY) **90**
NerveWire **56**
Netscape Communications (TWX) **104**
News Corp. (NWS) **146**
Nextel (NXTL) **24**
Nintendo (NTDOY) **50**
Nissan (NSANY) **132**
Nokia (NOK) **24, 50, 56**
Norfolk Southern (NSC) **94**

Novartis (NVS) **126**

O
Oracle (ORCL) **56**
Orbitz (ORBZ) **62**
Orient Overseas Container **58**

P
Paramount Pictures **62**
Parthenon Capital **82**
Patagonia **23**
Pepperidge Farm (CPB) **134**
Pfizer (PFE) **100**
PhoCusWright **62**
Priceline.com (PCLN) **62**
Procter & Gamble (PG) **94**
Prof-Media News **14**
Progressive (PGR) **23**
Publicis (P) **82**
Pulte Homes (PHM) **100**

Q
Qwest Communications (Q) **82**

R
RealNetworks (RNWK) **42**
Red Hat (RHAT) **122**
Renaissance Fund Advisors **146**
Roxio (ROXI) **42**

S
Samsung Heavy Industries **58**
Servigistics **86**
Silicon Graphics (SGI) **104**
Silver King Communications **62**
Silver Lake Partners **104**
Six Continents **62**
Sontra Medical (SONTC) **146**
Sony (SNE) **42, 50, 56, 90**
Sony Ericsson **24**
Southwest Airlines (LUV) **94, 138**
Sparx Asset Management **132**
Spectramind **56**
Spirit Airlines **138**
Sprint PCS (PCS) **24**
Standard & Poor's (MHP) **62, 144**
Starwood Hotels (HOT) **62**
Steel Dynamics **32**
Subaru **86**

Sun Country Airline
Sun Microsystems (SUNW) **14, 122**
SuSE **122**
Suunto **14**
Synopsis **104**

T
3M (MMM) **32**
Ticketmaster (IAC) **70**
Time Warner (TW) **146**
T-Mobile (DT) **24**
Tokyo Gas **90**
Toshiba (TOSBF) **94**
Toyota (TM) **90, 138**
TradeCard **86**
Trust Co. of the West
TSX Group (TX) **146**
TXU (TXU) **82**

U
UBS (UBS) **130, 146**
United Airlines (UAL)
United Technologies **94**
U.S. Bancorp (USE)

V
VA Linux **104**
Value Line (VALU) **104**
Vanguard Group **138**
Verizon (VZ) **24**
Virgin Atlantic **138**
Vivendi (V) **46, 62**
Vonage **16**

W
Wal-Mart Stores (W) **32, 42, 62**
Walt Disney (DIS) **138**
Washington Mutual **44**
WellPoint Health Net **126**
Wells Fargo (WFC) **138**
William Morris Agency
Wipro **56**
Wolverine Procter & Gamble
Schwartz **82**
WorldCom **26**
W.R. Berkley (BER)

X
Xerox (XRX) **94**

Y
Yahoo! (YHOO) **62**
Yankee Fleet **88**
YouGov **55**

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13380

Don't Blame Job Woes on China

THERE ARE PLENTY of reasons to criticize China. It has been slow to protect the intellectual-property rights of U.S. and other foreign companies. It has not opened its financial markets much to outside investment. It promotes "national champions" in its computer, auto, and software industries. But the China-bashing now under way in Washington has little to do with serious economic criticism.

As the Presidential-election season heats up, politicians in both parties are scapegoating China for the jobless recovery. To curry votes in Midwestern and Southern states, they are blaming China for the sharp decline in manufacturing jobs rather than the structural economic changes that are really behind them. As a result, they are pressing Beijing to revalue the yuan to curb exports or face a 27.5% tariff on Chinese imports into the U.S. These politically driven measures are economically misguided and could boomerang (page 32).

For starters, U.S. consumers and businesses benefit mightily from low-cost imports. Moreover, China is the fastest-growing U.S. export market. America's exports to China are up 21% year on year, compared with 2% to the rest of the world. Thanks to double-digit jumps in real annual wages and fast-growing retail sales, China's domestic market is booming. General Motors Corp. recently sold more cars in

China than in Europe. And China imports more than Japan.

Foreign-exchange rates have little to do with the shift in manufacturing jobs to China. U.S. companies sent products to China in the '90s when both the yuan and the dollar (which are linked) were strong relative to the yen and European currencies. Today, they are still sending production to China as the yuan and the dollar weaken. Does anyone really think a 30% revaluation will bring the toy industry back to the States?

The fact is, an integrated Sino-American economy linking business and finance is emerging. China is the supply chain for Corporate America. Parts are made around the world, assembled in China, and shipped to the States by American companies under such names as Dell, Boeing, and General Electric. In fact, 10 of the top 40 exporters from China are U.S. companies. Without China, American corporations would be less efficient, less profitable, and would pay lower wages at home.

China is the only engine of global growth besides the U.S.

And without Chinese money, the U.S. would be unable to finance its budget deficit. The failure of Americans to save requires the U.S. to import sums of capital. Private overseas lenders have cut their holdings of U.S. stocks and bonds. China's central bank has stepped in, buying billions in Treasury paper and helping to keep U.S. interest rates low. China is playing a major role in the U.S. recovery, just as the U.S. is boosting growth in China.

Certainly, China should live up to its obligations to the World Trade Organization. But the U.S. and China have created a mutually beneficial economic synergy. It should not be undone by political expediency or demagoguery. Shame on Republicans and Democrats alike. They should know better.

Washington's Fiscal Fantasies

OCT. 1 MARKED THE BEGINNING of the new fiscal year for 2004. It should be a moment for all Americans to take stock of their fiscal future. The projected budget deficit, thanks partly to an unanticipated \$87 billion bill for Iraq, is \$600 billion. Add that to the fiscal 2003 deficit of \$450 billion, and the U.S. will have to borrow more than \$1 trillion just to cover the cost of two years' worth of federal government. The numbers are staggering—and they're certain to grow. Yet the Bush Administration and Congress live in a fantasy land where choices don't have to be made, tax cuts have no limits, spending is unbounded, and

policymakers expect a *deus ex machina* to rescue them.

Washington must end these fiscal fantasies. The worst supply-side canard that tax cuts pay for themselves through economic growth. The Congressional Budget Office, now headed by a supply-sider, admits that it can't happen. Another fantasy is rebuilding Iraq will be short, cheap, and shared. After the recent U.N. meeting, it is clear that the White House's unilateralism has left it isolated. U.S. taxpayers will bear the cost alone, possibly hundreds of billions of dollars. Another fantasy is that fiscal obligations to the baby boomers can be ignored. Unless choices are made, this generation will eventually draw down benefits equal to 8% of GDP annually for Medicare plus 7% of GDP for Social Security.

The final fantasy is that we are still living in an era of big government. The reality is that big government is back. Terrorism, conflicts abroad, an aging population, and restoration of business and financial confidence are expected to increase the role of government. Americans must come to grips with the need to pay for what only government can provide.

It is fortuitous that the 2004 fiscal year is beginning as the Presidential campaign is taking off. Everyone running for President should tell the American people how they plan to get the country out of its deep fiscal crater.

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TERY (P.120)**

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NOW
PAY (P.66)**

**LEGE
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EXCESS
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(P.100)**

UNMARRIED AMERICA

Nearly half of all households are now headed by people who **aren't married.** How the new demographics will change business, politics, and society.

**BY MICHELLE CONLIN
(P.106)**



Mark Cunha, single parent, with his son, Nicholas, and daughter, Celine

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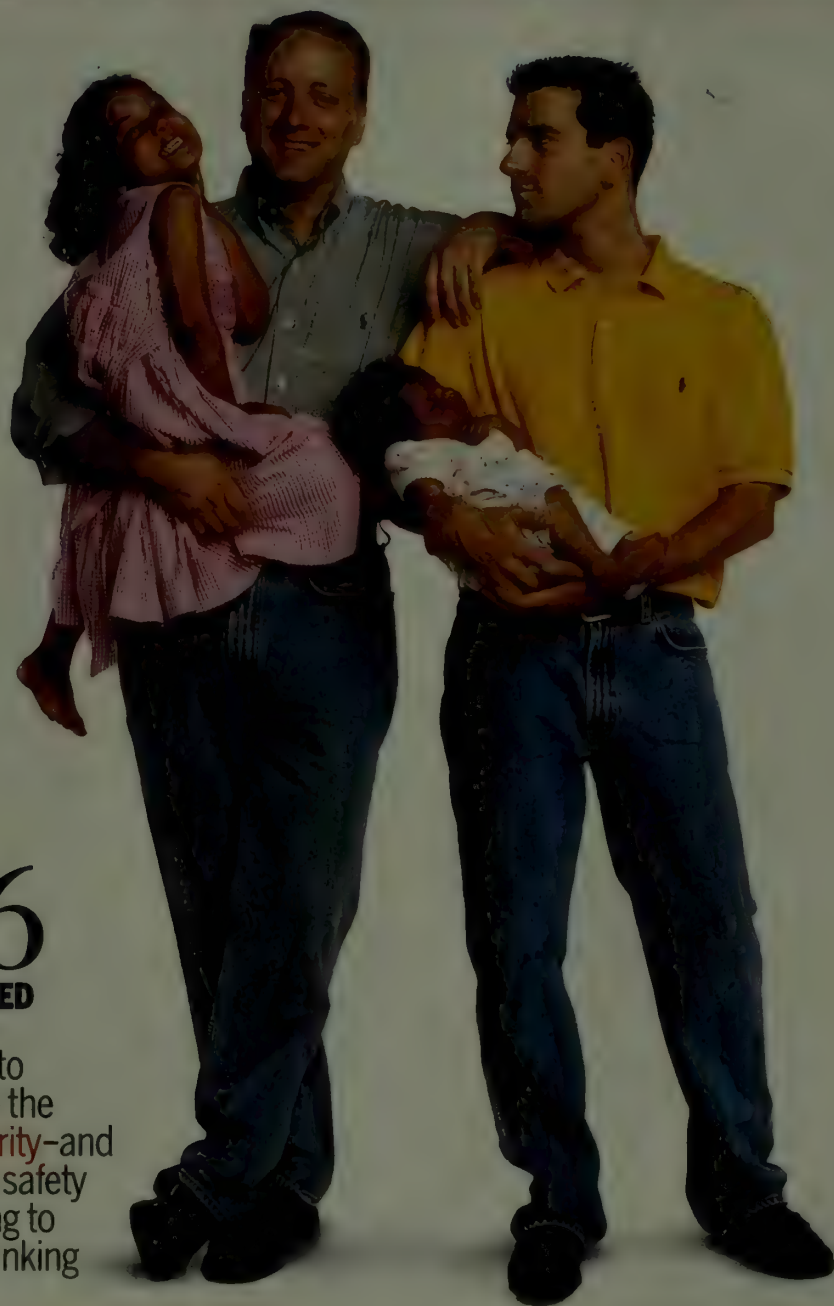
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106

UNMARRIED AMERICA

It's about to constitute the new majority—and the social safety net is going to need rethinking



86

EXECUTIVE MBAs
BusinessWeek ranks the best

36

CALIFORNIA

What has to be done—and the odds of doing it



Cover Story

106 Unmarried

Wedded couples will soon make up fewer than 50% U.S. households. This demographic upheaval will have vast consequences for Corporate America, government institutions, and the legal system

116 Commentary: The Marriage Bill

A Bush plan to spread the wedlock gospel is not apt to save the institution

News: Analysis & Commentary

36 California: Something's Gotta Give

The huge task Schwarzenegger faces likely to shake his no-new-tax pledge

39 Commentary: The Recall

As California goes, so goes the nation

40 High Tech: Some Help Wanted

It's no boom, but small outfits are starting to recruit people

42 The Sticker Shock in Health Care

Premiums and co-pays are up, up, up

46 Was There a Health Hazard at IBM?

Workers are alleging negligence in a

48 Statistical Laureates

Clive W.J. Granger and Robert F. Engle win the Nobel prize in economics

50 Mutual Funds in the Crosshairs

Eliot Spitzer's probe is closing in on widespread trading abuses

54 The Pickup Truck Wars: Enter Japan

Nissan's full-size Titan is set to roll

56 In Business This Week

International Business

60 Russia: Yukos

Why is the Kremlin going after the oil giant just as it may be near a megadeal?

62 Asia: Liquid Crystal Profits

Cashing in on the demand for LCD TV

Commentary: Japan

7 a showdown on the yen isn't likely

International Outlook

trade crusade of Brazil's President is
from finished

Economic Analysis

Economic Viewpoint

ker: The productivity boom is just
ing warmed up

Business Outlook

: More jobs, but no surging payrolls
y: Berlusconi's pension plan

Government

Washington Outlook

ley Clark is giving his fellow
tenders a run for their money

South Carolina Shakeout

Democratic Presidential contenders,
future may be decided there

Information Technology

Wildstrom: Technology & You

rosoft sneaks into your living room

Napster is Back—Sort of

new owner is making nice with the
sic industry. But will fans return?

The Corporation

Sempra's Golden State

other California energy players
shed, it figured out how to prosper

Environment

Putting Carbon Dioxide in Its Place

questering" emissions could help

Special Report

The Education Edge

ed on surveys with both alums and
gram directors, *BusinessWeek* again
ks the best executive MBA programs

Turbocharging Your Career

BA students are demanding more in
ns of rigor and relevance

You Don't Get What You Pay For

chools give EMBA's little career help



120

FOLLOWING THE MONEY

Ted Ammon's murder
is still unsolved, but a
BusinessWeek
accounting shows **what**
happened to his money

Sports Biz

100 A Whole New Ball Game?

College sports may finally be ready for
serious change, as a reform coalition
starts to gain ground

Finance

118 Turning a Spotlight on the Merc

A review of public documents shows
that governance of the futures-trading
bourse shares the NYSE's conflicts

120 Ted Ammon's Tortured Fortune

The murder victim was once worth
\$200 million. What happened to it all,
and who will get what's left?

Science & Technology

137 Super-Radar, Dirt Cheap

A system using ubiquitous cell-phone
signals is on its way

147 Developments to Watch

How SARS outsmarts killer cells; canes
that have their own sonar; RFID chips so
cheap they'll be everywhere

Workplace

148 Goodyear's New Deal With Labor

Instead of demands, the United
Steelworkers brought a strategic plan
when it came time for contract talks

149 A Talk with Ron Bloom

An investment banker-turned-USW
bigwig offers a rescue plan for Goodyear

Personal Business

152 Prime Time for Prime-Rate Funds

Also known as bank loan funds, they can
protect you against higher rates

154 The New Pinch in Health Coverage

Plans are costing more—again

156 New Oxymoron: Cool Minivan

The latest Toyota and Nissan models
sport lush interiors and smart designs

157 Cordless—And Hands-Free, Too

How headset phones stack up

158 Earnings: What to Listen For

This time out, revenue growth will have
a greater impact on stock prices

162 Footnotes

Borrowing against Breughel; old-timey
fantasy baseball; paying bills online

164 The Barker Portfolio

Newell Rubbermaid: Why it may bounce
back from its current crisis

166 Marcial: Inside Wall Street

Features

13 UpFront

18 Editor's Memo

19 Readers Report

20 Corrections & Clarifications

24 Books: Symonds: *Softwar*
Southwick: *Everyone Else Must Fail*

168 Figures of the Week

170 Index to Companies

172 Editorials

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The Technology of Finance

To comply with strict new financial-reporting rules, CFOs are turning to high-tech systems that can provide vital info accurately and quickly



Even the Well-Heeled Feel the Pinch

An improving economy doesn't necessarily mean good times are here again for America's highest earners. They saw their income drop 5% last year, and the trappings of the good life have become more expensive

It's a Hollywood Halloween

So long soldier and fireman costumes. It's back to fantasy and fun, à la *Pirates of the Caribbean* and *Spider-Man*



The Socially Responsible B-School

MBA students looking to balance the profit motive and the desire to provide community support are seeking MBA programs that include social and environmental topics. Now, a new study rates schools on this issue

Two Stocks in the Pet Penthouse

Booming demand for animal food, supplies, and services has the shares of PETSMART and PETCO performing like champions



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JP Front

"These two didn't win the jackpot, they stole it"

—Kenneth Chalifoux, N.Y. assistant district attorney, in his opening argument in the trial of former Tyco executives L. Dennis Kozlowski and Mark Swartz

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VICTIMS OF FATE THE CRASH THAT CRUSHED QUARTER

STOCKHOLDERS ARE wondering if a truck accident could blow off sales at drugmaker Biogen. The company says because a truck carrying Wellbutrin XL antidepressant was in an accident on Oct. 1, third-quarter sales will drop by at least \$15 million—and off for the year. Biogen, however, is being careful about the value of its drugs. It has disappointed investors two quarters in a row. Now, it appears more than half the company's quarterly sales may have been shipped in that truck. On Oct. 30, "There are serious questions," says analyst David Marris of Banc of America.



BIOTERROR ZONE
Incidents
happen

America Securities.

Biogen is just being

conservative, says Ken Kessler, vice-president for Biogen. So far this year, the company has shipped \$20 million of the drug—well below its \$60 million target.

—Diane Brady



CAR TALK

Meet the Lutzmobile

WHEN GENERAL Motors brought retired Chrysler car guru Robert Lutz on board two years ago, his first mission was to build a cool sports car for Pontiac. *BusinessWeek* has learned that GM will build the car, likely

showing a production-ready version of the model at the Detroit auto show in January. The Pontiac Solstice is a sexy two-seater that will cost a little more than \$20,000 and could hit showrooms as early as 2005.

GM wants the Solstice to give Pontiac real sports-car cachet, as the Miata gave Mazda when it came out in the mid-1980s. Pontiac plans to price the Solstice below cars like the Miata to lure younger buyers. But building a sports car with a low sticker price that can be sold profitably is no easy task.

To cut production costs, GM will fashion sections of the car's frame via a process called hydroforming, which uses water at high pressure to bend steel tubes into shape. That's instead of stamping individual pieces out using big, expensive dies. The frame will cost GM \$150 million—roughly half what rivals spend to get a sports car rolling—and could be used to build sporty cars for Buick or Saturn. Then GM could be cruising in style.

—David Welch

THE BIG PICTURE

STOCKING UP The largest buyers, in the last three years, of conventional weapons among developing nations:

SAUDI ARABIA

BILLIONS
\$26.6

CHINA

\$6.1

TAIWAN

\$6.0

EGYPT

\$4.7

SOUTH KOREA

\$4.5



Data: Congressional Research Service

BUYER BEWARE READERS CRY FOUL OVER THE FEE FRENZY

BUSINESSWEEK's Sept. 29 cover story, "Fees! Fees! Fees!" showed how hidden charges have become part of pricing. It sparked a spate of letters—so many that we've started a discussion group at businessweek.com. Here's a sampling:

■ **FirstMerit Bank** charged David Myers in Chippewa Lake, Ohio, \$30 to halt an automatic withdrawal from his bank account. The bank says this is a published fee in line with those charged by other banks.

■ Cheryl Taylor in Chesterfield, Mich., says Sprint charges people \$5 to pay their bill at their service counters. "What does 'service' mean to them?" Taylor writes. "And why on earth would they charge you to give them money?" Sprint says there are free payment options and that the fees help manage staffing and related expenses.

■ Alfred Dombrowski of Depoe Bay, Ore., paid Orbitz \$74.66 for a hotel reservation. When he checked out, he discovered the room cost only \$58.41—the extra \$16.25 was an Orbitz fee. Orbitz says

the hotel mistakenly gave Dombrowski a receipt showing the wholesale rate.

■ Don Wiss of Brooklyn, N.Y., says a \$169 **American Airlines** special round-trip fare to Bermuda had taxes and fees adding \$73.20 to the price. American says the additional charges are actually even higher—\$75.70.

■ Igeborg Allen of Ontario, Calif., tried to avoid **Ticketmaster** fees by

going directly to the venue but found fees applied there, too. "I have not attended an increasing number of events because the fees make a \$6 ticket cost more than \$10," she writes. "That is just a ridiculously high fee to process a credit card and print tickets." Ticketmaster says it splits fees with the venue and the promotion company.

—Emily Thornton



TRADE WINDS

CHINESE JUNK U.S. jobs aren't the only thing being exported to China. U.S. junk is, too. Scrap-metal companies are going gangbusters thanks to big demand from China, which turns the scrap into finished steel for building projects. That has driven scrap prices sky-high. Daniel Dienst, chairman of recycler Metal Management, is shipping scrap to China at \$188 per ton, twice the price of two years ago. This has helped companies such as Metal Management and Schnitzer Steel, which have shed debt and shined up their balance sheet. Schnitzer's shares have gained 270% on the year, closing at \$37 on Oct. 8. What's that old saw about one man's trash? —Brian Hindo

DRAWN & QUARTERED

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FACE TIME

SRI SRI RAVI SHANKAR



SOOTHING THE VALLEY OF LOST JOBS

Sri Sri Ravi Shankar, a 47-year-old ascetic, has become the guru to the digerati. Disciples say his Art of Living classes—known to his 4 million followers by the techie acronym AOL—help them find meaning and relief in their stress-filled jobs.

Sri Sri is a disciple of Maharishi Mahesh Yogi, who brought Transcendental Meditation to the West in the 1960s. Now his followers give \$150-a-head seminars at Oracle, Sun Microsystems, and Cisco. "The knife of job loss is hanging over our heads. The fear leads people to join the courses," says Ravi Phatak, an Oracle engineer who runs the seminars. As long as tech remains stressful, Sri Sri will have disciples. —Manjeet Kripalani

IRAQ

A WEB GOLD MINE GOES UNTOUCHED

IT DOESN'T HAVE reliable running water or electricity, but Iraq might be sitting on a lucrative high-tech asset. The country's Internet address, .iq, has languished since December, when the FBI raided the Richardson (Tex.) offices of InfoCom, the manager of the address. The FBI arrested four employees: CEO Bayan Elashi and three of his brothers, also InfoCom principals. The FBI claims InfoCom was funneling computer equipment and funds, including fees for registering .iq sites, to terrorist groups. Elashi's case is set to go to trial on Mar. 8.

Meanwhile, the Internet address sits idle when it could be generating revenue for Iraq. All government officials have to do is sell Web addresses with the .iq designation. One holdup: The Internet Corporation for



Assigned Names & Numbers (ICANN), which governs domains, is reluctant to re-delegate .iq without a nod from Baghdad. *BusinessWeek* has learned that the fledgling Iraqi Communications Ministry is planning to petition ICANN for ownership of the address.

A competing bid has been made by Onega, the London-based manager of the .uk address. However, its Committee for Information Technology Reconstruction in Iraq is having trouble

raising money to woo political leaders in Baghdad to support its own bid. With Iraq in disarray, Internet infrastructure isn't a top priority. "It would be great to have a team of lobbyists," says Onega director Ben Fitzgerald-O'Connor. But .iq domain isn't on the Pentagon's radar, a spokesman concedes. First they've got to get the water and electricity running.

—Lorraine Woellert, *Wall Street Journal*
Laura C.

REALITY CHECK

PROFITS: NOT AS GOOD AS THEY LOOK

WHEN THE COMMERCE Dept. gives its first estimate of third-quarter growth on Oct. 30, it's likely to say corporate profits were running at an annual rate of nearly \$1 trillion. But that mouth-watering number could be misleading. On closer look, profits are still anemic, says Merrill Lynch economist Ron Wexler. His case:

■ **Profit figures may be inflated:** While the net income of the S&P 500

doubled from the end of the recession through the second quarter, operating cash flow rose just 3.8%.

■ **Aftertax profits are weak:** They're up 4.7% since the end of the 2001 recession, as measured by the government. This far into most other recoveries, profits were up 39% on average.

■ **Profit margins stink:** They were just below 10% in the second quarter. At this stage in most other recoveries, they were 11% to 20%.

But don't despair. Margins are so thin that even modest growth will translate into a big percentage gain in profits.

—Peter Coy

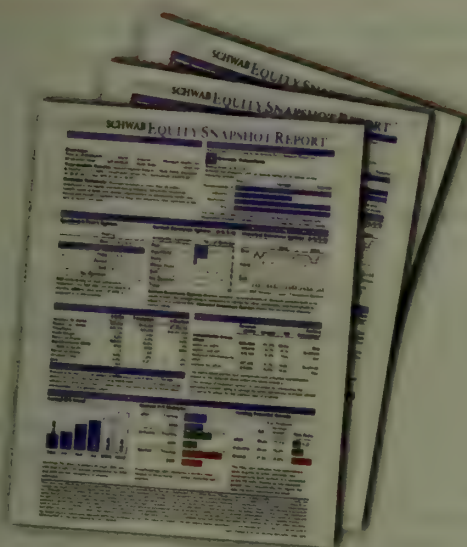
THE STAT

10%

The yearly earnings hit MGM Mirage could suffer from the loss of its *Siegfried & Roy* show. On Oct. 3, Roy Horn was mauled by one of his tigers.

Data: Deutsche Bank

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Majoring in B-schools

BUSINESSWEEK HAS LONG BEEN THE LEADER in covering the B-school scene. Since 1988, our biennial "Best B-Schools" survey (Oct. 21, 2002) has been the most comprehensive anywhere, drawn from MBA students and the recruiters who hire them. Every other year we turn our sights to education

programs for executives. We do it two ways. We pick the best programs for nondegree executive education, based on a survey of corporate managers and human resource directors. We also rank the best programs for the Executive MBA, drawn from a survey of more than 4,000 recent alumni plus 64 EMBA program directors.

On the nondegree side, the 134 companies in 20 countries that participated in our survey sent more than 21,400 employees to exec ed courses in the past year, spending \$210 million in the process. For the first time, we separately rank open-enrollment programs and customized programs designed for individual companies. When it comes to the EMBA rankings, this year we found that fewer companies are picking up the tab—a change from our previous survey in 2001.

Meanwhile, our B-schools channel on BusinessWeek Online (businessweek.com/bschools) continues to provide a wealth of free information, including our exclusive rankings of the 50 top full-time MBA programs and profiles of more than 300 others; rankings of the best EMBA and exec-ed

programs; and a calendar of events at major B-schools. Our interactive forum now has more than 850,000 messages nearly twice as many as a year ago.

We've also just launched a new subscription area on BusinessWeek Online, MBA Insider. The Insider, at \$29.95 a year, is a road map for the more than 100,000 candidates who apply to B-school each year. It provides insight into which areas of study and which schools might be the best match, plus advice on how to get in from students, grads, professors, and admissions officers. Also: application essays that made the grade, campus photo tours, and a variety of interactive tools. The Insider is updated regularly by our BV B-School team of Jennifer Merritt, Jessica Loudon, Mica Schneider, Brian Hinds, and Joshua Tanzer.

Anyone who aspires to an MBA will learn more than ever from these, our latest forays into the world of management education. ■

Stephen B. Shepard

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W How can we ever expect transparency in corporate reporting if we **struggle** to have transparency in pricing?

—Philip E. Howe
Lehigh Valley, Pa.



FEES! FEES! FEES! (Cover Story, Sept. 29), the proliferation of hidden charges, prompted a huge response from readers. They reported even more egregious fees. A collection of the best of the best—or worst—see UpFront (page 14).

TRICKY BUSINESS OF FEES

FEES! FEES! FEES! documents the cement down the path toward mediocrity. On one hand, businesses feel that they have to bribe customers to accept their products and services. On the other hand, they will take advantage of the customer's inaction to hit us with an array of fees. In the midst of all of this, they continue to cry that they can't raise prices. If they can offer the customer is game-changing, they don't deserve to charge higher prices.

Perhaps this troubled model of their customers is what led to their products and services being priced as commodities. How can we ever expect transparency in corporate reporting if we must struggle to get transparency in pricing?

—Philip E. Howe
Lehigh Valley, Pa.

STATE GOVERNMENT attorney representing Maine's telecommunications customers, I regularly hear from customers who are furious about the number of indecipherable surcharges on their phone bills. While you mentioned that fees typically add 15% to the cost of long-distance service, you neglected to mention that fees and hidden rate components on local phone bills typically add over 50% to the total price. "Anatomy of a phone bill" on our Web site has an explanation of each phone surcharge (<http://www.me.us/meopa/phoneanatomy.htm>).

—Wayne R. Jortner
Senior Counsel, Maine Public Advocate
Augusta, Me.

ING FEES to a company's revenue is the equivalent of incremental

cost-cutting on a company's cost structure. What seems like an effective way to improve margins and profits usually results in lost revenues and added costs after the initial benefits are realized.

Fee-based pricing tactics ignore the economic value of quality customer relationships, as well as the high cost of customer churn and added process complexity. Besides, most companies targeting revenue growth appreciate that their existing customers are their best candidates for new service offerings that drive up revenues without price increases.

—John G. Carlson
Andover, Mass.

BANKS: SOCKING IT TO YOU

THE PROBLEM WITH BANK FEES goes way beyond their being assessed. I have found on behalf of clients (and personally) that most of the time an error is made, such as an assessment on a closed account, that: 1) the collection department will not respond to letters of explanation; 2) telephone collectors never have authority to correct an error, only to demand payment; 3) the fact that letters have been written is not even entered into the collectors' database; and 4) the same person never calls twice. And when the account is turned over for collection, the banks never furnish to the collection agency or lawyer the letters previously written to try and correct the error.

—Lowell N. Hawkes
Pocatello, Idaho

YOU SAY BANK OF AMERICA has stopped charging fees for online banking. However, they hold payments you make for five business days before forwarding them to the payee, allowing the bank to use the float as a source of funds.

—Robert Grass
Des Moines, Wash.

CONTRARY TO THEIR CLAIM in your article, Provident Financial Corp. now

Middleware. It's on Broadway.

Readers Report

CORRECTIONS & CLARIFICATIONS

"Now, this is going to hurt..." (Up Front, Oct. 13) erroneously stated that hospital chain HealthSouth had entered into bankruptcy. HealthSouth has not filed for bankruptcy and is not expected to do so.

In "What's squeezing banks" (Finance, Oct. 6), a quotation from a report by Morgan Stanley analyst Betsy Graseck was taken out of context. Her point is that bank accounting requires held-for-sale securities portfolios to be marked to market, while most other assets and liabilities are not. So when rates rise, investors see the decline in value of the securities portfolios, but they don't see the increase in value of the loan book and core deposits.

The illustration accompanying "Global downloading, local lawsuits" (International Business, Oct. 6) should have been credited to Richard Borge.

In "Fliers' dilemma: Save now or later" (Personal Business, Oct. 13), the number of round trips needed for a free flight on JetBlue Airways should have said 13 short-hops within a year, not 13 medium-distance trips.

charges \$12.95 to make a same-day online credit-card payment, a service that was free last year.

—Glenn Daley
Torrance, Calif.

SOME CHARGES ARE FAIR

GOOD ARTICLE, BUT YOU tell the story from only one side. Take Best Buy restocking fee: I would rather have them charge a fee to someone who "bought a camcorder for the weekend" than raise the price to cover the loss of not being able to sell the opened box as new. The same for other products and services mentioned that I may not need or want, such as food on the airline or extra housekeeping at a hotel.

—Bob Oswald
Chandler, Ariz.

WHEN FEES BECOME ABUSE

FEES, CHARGES, PENALTIES? I can top that. How about being whacked when the vendor cannot provide the service? I recently moved two blocks away, and Earthlink, my DSL supplier, claimed that it could not provide service at my new place, so they socked me \$150 for "early termination." No amount of reason or abuse would shake them from this

shakedown. Happy coda: I signed up with my local cable monopoly. No complaints so far.

—Ian Keay
Palo Alto, Calif.

IN RECENT YEARS, software publishers have hit consumers with a double whammy that very likely escapes the consumer price index. First, many have stopped providing user's manuals, triggering the emergence of the "Missing Manual" and "Dummies" series of self-help books.

Second, they have virtually eliminated free real-person telephone tech support. Currently, after one or two "courtesy calls," users typically must pay \$30 to \$45 per help incident or \$2 to \$3 per minute using a 900 number.

—Bill Steinbicker
Minnetonka, Minn.

BEWARE OF ERRONEOUS FEES

HERE IS AN additional issue that should have been addressed: overcharges, "accidental" charges, and just plain erroneous charges billed by companies with access to consumer credit-card information. At

least twice a year—sometimes more ten—America Online Inc. charges me one month for 12 months, adding \$200 to my bill. When I call to report this, I told that the charge was an error and be credited back to me in 60 days. In fact, AOL gets an interest-free loan while I am being charged interest by my credit card company.

—Kelly Gutens
Stafford, Va.

LOYAL CUSTOMERS WEIGH IN

AMERICAN EXPRESS charges me nothing for paying online or having no real-time access to my account online and they have a bevy of helpful people reachable via phone. Merchants gripe about American Express charging them a higher rate, but hey, they do get my business.

—Lewis Per
Sonoma, Calif.

I HAVE LEARNED THAT companies typically respond well to good customers. As an example, I got my long-distance provider of the past 15 years to give me



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odwill" credit for the "regulatory ac-
fee recently added to my bill.

-Timothy E. Cheek
Coppell, Tex.

FINE POINTS MARKET TIMING

ASK: SHOULD YOU TIME the mar-
Of course you should (*BusinessWeek*
stor, Sept. 29). You hope your mutu-
nd managers do it. Timing is what
es executives to sell stock options.
Americans ignored the propaganda
their 401(k) statements, they would
timed the market and reduced their
s as the Dow fell from 11,000 to
O. If you don't time it, "invest" be-
es code for "hold the market up while
rs cash out" or "everybody took their
ts but you—now help push this mar-
ack up!"

-Roger Johnson
LeClaire, Iowa

ELUSIVE ECONOMICS DEFENDING FREEDOM

OULD YOU CARE TO TELL relatives of
e who lost family members in the

World Trade Center, the Pentagon, or the
planes, or tell parents of troops who gave
their lives, that \$87 billion is too much for
the U.S. ("The high cost of war," *News:*
Analysis & Commentary, Sept. 22)? Is the
new battle cry "Let's roll it up?"

-Dean Munson
Rockford, Ill.

I DO NOT BELIEVE the U.S. can afford
any more of President George W. Bush's
tax hypocrisy and suggest that he fund
his war with a \$1- or \$2-per-gallon surtax
on gasoline rather than his \$87 billion in-
crease to the massive deficit he already
has created.

-Milton D. Rosenau Jr.
Bellaire, Tex.

WHAT NOT TO WEAR ON THE FIRST DAY OF SCHOOL

I CAN ADD anecdotal evidence to your
analysis of the challenges facing Aber-
crombie & Fitch Co. ("No longer big
brand on campus," *Marketing*, Sept. 29).
I work at a university that just welcomed
its latest freshman class. Into the dining
hall, escorting his freshman son, came a

dad wearing a crop-top, sleeveless gar-
ment emblazoned "Abercrombie"—the
dad! The end is near.

Does anyone else remember A&F as the
posh brand of old-money, big-game-
hunter types?

-Bruce Holgers
Santa Cruz, Calif.

ROLE MODELS WITHOUT MBAs

IN "WHAT'S AN MBA really worth?"
(Cover Story, Sept. 22) it is very interest-
ing that of the people on your short list of
"most-admired business leaders," only
Warren Buffett actually has a business
education. Herb Kelleher studied law,
Michael Dell and Bill Gates dropped out,
Jack Welch got a PhD in chemistry, and
Oprah Winfrey [studied speech and dra-
ma]. An MBA is not a prerequisite to
starting a great business, but the three
letters look very nice on a résumé.

-Ankur Parashar
Boston

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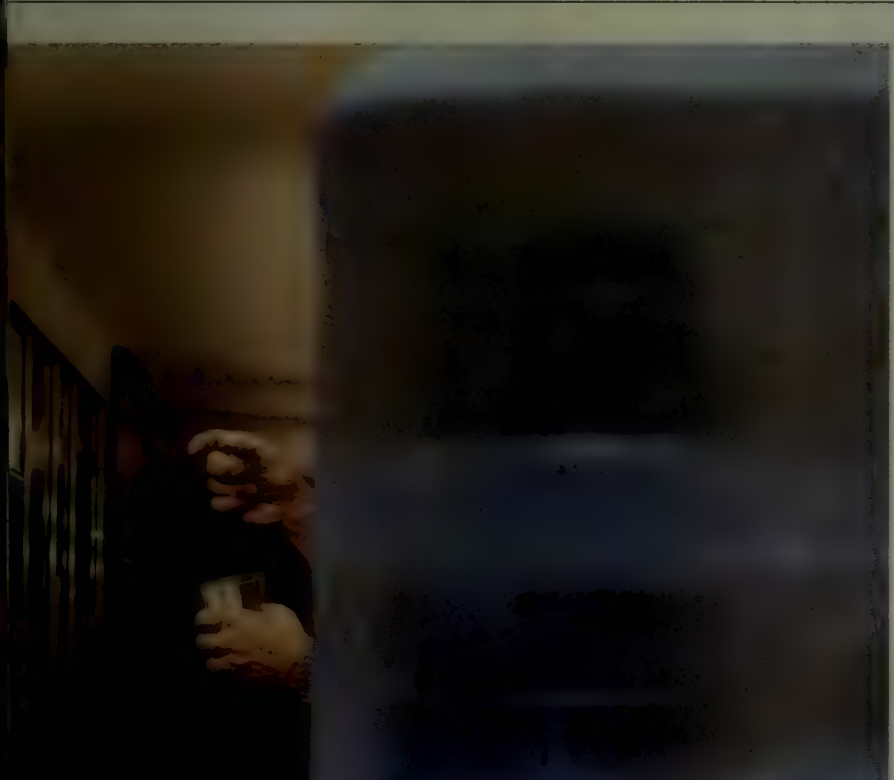
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is that we have the experience but you have an inbuilt infrastructure that is infinitely
le...people. Because we understand that in business, communication is everything.

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Oracle's Stormy Visionary

SOFTWARE An Intimate Portrait of Larry Ellison and Oracle

By Matthew Symonds; Simon & Schuster; 508pp; \$28

EVERYONE ELSE MUST FAIL The Unvarnished Truth about Oracle and Larry Ellison

By Karin Southwick; Crown; 320pp; \$27.50

Few Silicon Valley executives inspire such visceral reactions as Oracle CEO Lawrence J. Ellison. He's either a tech-industry visionary who sees trends before anyone else—or he's a megalomaniac who casually discards employees and whose self-indulgence could drag his software company over

a cliff. Just how you see him can depend on the mood you catch Ellison in or whether you're one of those casually discarded employees.

Both sides of Ellison are meticulously described in a pair of new books. The first, *Software: An Intimate Portrait of Larry Ellison and Oracle* by Matthew Symonds, political editor at *The Economist*, is an authorized and largely favorable account of Ellison's adventures in and out of the company's Oz-like, green-windowed headquarters. The second, due out in November, *Everyone Else Must Fail: The Unvarnished Truth about Oracle and Larry Ellison*, is a harsh—and sometimes scolding—account by Karen Southwick, executive editor at CNET's News.com and the author of three other Silicon Valley-related books. The first is better on Ellison the man; the second is better about his business.

Symonds, who spent more than two years on his book, struck a novel deal with Oracle Corp.'s CEO. Ellison gave the author near-unfettered access and complete editorial control. In return, Ellison got to respond, in footnotes, to Symonds' narrative. The result is an odd, running commentary by Ellison on Symonds' commentary on Ellison. The mogul seldom disagrees with the writer—and disappointingly, most of the often-sharp-tongued mogul's footnotes are focused on technical explanations of Oracle's business.

There are, however, a few stabs from Ellison. In the mid-1990s, Oracle President Raymond J. Lane was considering leaving Oracle to take over the corner office at struggling software maker Novell Inc. Ellison persuaded Lane to stay. But now, says Ellison in a note, "I should have let Ray go." In fact, several years later, Ellison forced Lane out of Oracle.

Symonds excels at letting readers into the 59-year-old Ellison's often-turbulent personal life. From the unhappy Chicago childhood, through three marriages and divorces, to a surprisingly stable relationship with fiancée Melanie Craft, a romance novelist 25 years his junior, it may well be the first complete picture of the private Ellison.

The author also provides a wonderful image of an Ellison

who is far from being all-business. Two years ago, after benefiting royally from the tech boom, Oracle fell short of Wall Street's expectations. It was an embarrassing experience for Ellison, who had publicly speculated that Oracle could emerge from the tech crash unscathed. A few days after the bad earnings news, Ellison hopped into a car with Symonds. He was distraught, on the verge of tears, and constantly on the phone with Craft. Why? His cat had just died.

But Symonds falls flat when he considers Oracle's business. He accompanied Ellison to meetings with customers around the world, but he doesn't describe Oracle's often testy

relationship with them. The author can be too kind as when he fails to recount fully the bugs in Oracle's software, which handles processes like companywide financials and customer management. Just when he should call the mogul on the carpet, Symonds settles

for Ellison's rationalizations.

Southwick has no such problems. She has a keen appreciation for Oracle's business machinations. And although she didn't enjoy anything like Symonds' access, she did get several interviews with Ellison. The result is a tough, gimlet-eyed view of Oracle, largely via the experience of people Ellison has ticked off over the years.

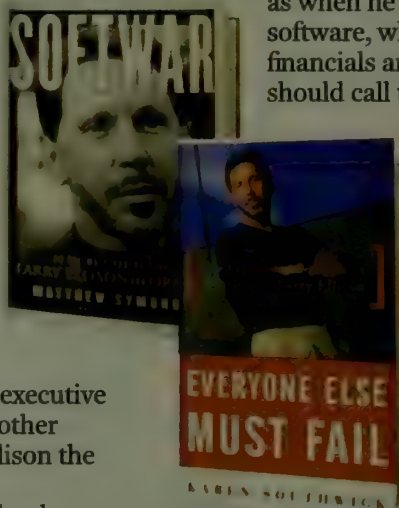
Southwick nails the colder side of Ellison. When Oracle was nearly forced into bankruptcy in 1990, because of its sales force's questionable accounting practices, Ellison didn't take full responsibility, says Southwick. She also details the row between Ellison and Lane, whom she says Ellison viewed as a threat.

But Southwick goes too far when she says that Ellison's war could drag Oracle into ruin. Certainly, Oracle has had trouble finding revenue growth in the past two years and has missed prime

opportunities. But every quarter, it turns a profit larger than any software company not named Microsoft Corp.

The authors agree on one thing: Oracle can be a most unpleasant place to work. Each provides numerous examples of bitter former Oracle execs, many of whom left to run rival companies. Perhaps that's the final lesson: Larry Ellison is brilliant, charming—but ruthless. And as with any person with outsize ambitions, it's best to stay out of his way. ■

—By Jim Kerstein



Symonds' book is kind. Southwick's gives a far harsher view

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Joyce Vonada, CIO
AutoNation, Inc.



INFRASTRUCTURE FOR THE ON-DEMAND ENTERPRISE

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have some words of advice.

"Think twice," the two say almost in unison, sheepishly recounting their own grueling experience. "And if you're going to do it, don't do it the way we did it," adds Rat, who went into the business as a complete novice. "Make sure you've got some intro to the business as a complete novice. It's a lot easier if you have some first-hand world experience, even if it means a dead-end job."

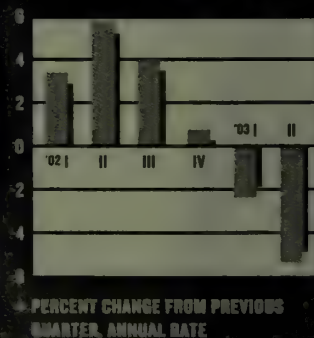
"I'm not!" Had we done it that way we might have been successful!

After negotiating the difficulties of financing, you'll need to consider location, which is when it's time to call in the experts. Location impacts everything from design and construction to licensing requirements and regulations, and these can be Byzantine labyrinths wherein money just seems to disappear. Of particular concern, most experienced operators say is the lease. "Expect to have ongoing problems with your landlord," says Leach. "Everything from noise to trash, cooking odors, traffic and sidewalk construction will present a problem."

And this is just the start of an extensive process. Consider some of the chapter headings found in *Waiter, There's a Fly in My Soup: The Hazardous Running of Our Own Restaurants*, by Chris Brignola, a successful St. Louis restaurateur who branched into bakeries and specialty stores. They include "Posing Sources, Dealing with Liability," "What, in a Name?" and "omph... How to Dodge That."

Everything from ^{decor} to menu to staffing and equipment presents prospective entrepreneurs with a myriad of complex and potentially expensive choices to make. Restaurant and bar business plans typically include sections on food and beverage costs, labor costs, insurance, advertising and promotion, furnishings, maintenance, legal counsel, utilities, laundry and linen and more. This dizzying list of potential landmines is best negotiated by someone with steel nerves and a large bottle of ibuprofen, says Campbell. "There was just one headache after another," he recalls.

IS THE GLASS HALF EMPTY?



They're going to come in handy, too, as he and his partners begin the process of franchising their "Cutty's Roadhouse" concept outside the Boston Area. In this case, taking the bar or restaurant plunge may well pay off in big time.

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BY STEPHEN H. WILDSTROM

The Road to the PC-TV Runs through Windows

Slowly but surely, Microsoft is moving into your living room. After years of failed attempts by cable and satellite-TV companies to sell set-top boxes and receivers, it turns out that the product that drives the long-awaited convergence between computing and entertainment may be Windows—in the form of the Media Center PC.

Media Center is a version of Windows XP that lets users watch video on a PC—including real-time TV and shows recorded to a hard drive. It also lets you use a remote control to manage music on the PC from across the room. On Sept. 30, Microsoft introduced a more capable version of Media Center. The fresh edition fixes a number of the annoyances that marred the original, but it remains flawed in several important respects.

First, the good news: The software is better. For example, while the original Media Center made you launch Media Player as a regular Windows program to record music off a CD, the new software lets you do it with the remote. More important, nearly every maker of consumer PCs now has a Media Center offering, including Dell, which had passed on the first version, and Sony, which has been pushing a proprietary entertainment PC called GigaPocket. Gateway and Dell announced sub-\$1,000 products—remarkable given that manufacturers selling PCs with Media Center must also build in a TV tuner and other relatively high-end hardware, while paying a premium to Microsoft. Toshiba and Hewlett-Packard are offering Media Center notebooks.

AS HAS OFTEN BEEN THE CASE, Microsoft's competitors have become its unwitting allies in the struggle to dominate the living room. Consumer-electronics companies make networked products, but they are mostly single-function appliances, such as DVD players or video recorders with hard drives. The products do not work well together and can be more difficult to set up than networked computers. Cable providers have talked for years about advanced set-top boxes that offer video recording and movies on demand, but deployments to consumers have been scarce.

The new Media Center is a bona fide advance over these, but it still has a ways to go. The bad news is that the analog-TV tuners installed in PCs aren't very good. You'll get a better picture on a \$200 television. The monitor is another issue. TV pictures do not look very good on computer



displays, whether CRT or LCD, which are optimized for the display of text and graphics, not video. You can use your TV as a display, but even a flat-panel model is not ideal. I used a prototype Media Center with a \$4,000 Mitsubishi 22-inch LCD TV, a fine set that produced ravishing images from recorded high-definition video. But poor text quality makes it a lousy computer monitor. (Attaching both a PC monitor and a television is another option—but ill-suited to the living room.)

Microsoft's rivals are unwitting allies as it elbows into living rooms

Media Center is important for PC makers because the entertainment features give consumers a reason to buy top-of-the-line computers, which have much better margins than cheap PCs. For Microsoft, Media Center is a lot more than that. The company wants to dominate the online distribution of movies, music, and the like through Windows Media technology, which includes piracy-thwarting technology

Hollywood desires. While the consumer-electronics companies argue about technical standards in myriad task forces and working groups, Microsoft is getting products into consumers' homes. Ultimately, home media centers will have to be a lot cheaper and simpler than the Media Center PC—more like a set-top box or Xbox game console and less like a computer. In the meantime, Microsoft is getting a big leg up on the competition. ■

E-mail: tech&you@businessweek.com

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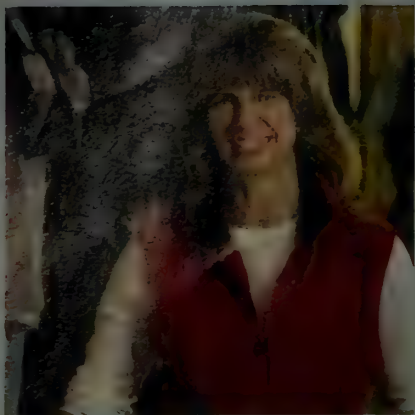
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BY GARY S. BECKER

The Productivity Boom Is Just Warming Up

The American economy is beginning to pick up steam, with growth of annualized gross domestic product in the second quarter of 3.3% and a continuing boom in productivity. The evidence on productivity is particularly important since growth in technology and productivity are the most significant determinants of improvements in the standard of living.

After bumping along at a rather slow pace in the latter half of the 1970s and '80s, productivity began to rise more rapidly in the mid-'90s. Output per worker increased at the rate of 1.5% per year from 1995 to 2000, and total factor productivity—which measures output relative to the amount of capital as well as labor—also grew at a fast clip. In the past, productivity almost always fell during recessions because both labor and capital were underutilized and output sagged or grew more slowly. But the apparent paradox of the past few years is that labor productivity has grown even more rapidly since 2000 than in the '90s, at a 2.5% clip. This occurred despite the recession that started in March, 2001, and a slow recovery since the recession ended in November of the same year.

The large spurt in technological progress during the past eight years is mainly due to a series of developments: rapid progress in computer capabilities, the explosive growth of the Internet, advances in cellular and other wireless technologies, growth of fiber optics, advances in biotech, greater world competition for U.S. companies—which induced improvements in business efficiency—and myriad other smaller improvements in technology.

THE IMPACT OF SOME of these events cannot yet be quantified, but the importance of information technology is documented by several statistics. During the boom years from 1995 to 2000, almost all of the improvements in productivity were due either to investments in information technology or to advances in the output of information-technology goods. However, the productivity gains of the past several years are much less dependent on IT and are more widespread in the economy.

I continue to believe that even after the burst of the bubble in high-tech stocks, the U.S. economy is in the relatively early stages of a major technological revolution. The previous tech advance started at the end of the 19th century and was due mainly to the development of both the electric motor and the internal-combustion engine. It took 40 to 60 years for that revolution to be fully reflected in productivity improvement. The recent speedup in productivity growth suggests that the current revolution is progressing along similar lines. If so,

prospects are excellent for long-term growth in output per worker at a rate of 3% per year or higher for perhaps decades. Income per worker could double in 25 years or less.

Some economists have blamed much of the apparent decline in employment since the onset of the recession on the rapid improvement in technology. In a mechanical sense, that is a plausible view: If the growth in output is fixed, employment could fall if labor productivity improves a lot.

But the growth in output is not fixed. During the boom after 1995, employment grew rapidly alongside productivity. Rapid advances in both employment and productivity indicated that output also grew substantially. In the longer run, employment tends to grow at about the same rate as the increase in the labor force, even when productivity is advancing rapidly.

Output per worker may grow at 3% or more a year for decades

Moreover, there is controversy over what has been happening to employment, with two government surveys giving very different pictures of the changes in employment during this recovery. The data usually cited come from surveys of company payrolls, and these show rather large declines in employment since the start of the recession. However, the Labor

Dept. also asks households about employment, and this shows a rise in employment during this time. These surveys sometimes give conflicting pictures partly because the household survey more quickly detects employment at new companies. It is possible that the number of new companies grew significantly during this recovery.

The relatively high unemployment rate and apparent decline in employment gets most of the media and political attention. But the most significant news from the past few years is the continuation and possible acceleration of the sizable productivity advance that began almost a decade ago. ■

Gary S. Becker, the 1992 Nobel laureate, teaches at the University of Chicago and is a Fellow of the Hoover Institution.

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JAMES C. COOPER & KATHLEEN MADIGAN

A Jobs Recovery, Yes. A Hiring Boom, No.

Intense cost pressures and weak pricing will keep payrolls from surging

U.S. ECONOMY It's about time. The news that the labor markets might finally be turning around certainly elicited sighs of relief from the millions of job seekers who have been unable to find work despite two years of so-called economic recovery. The Labor Dept.'s report of a small gain of 57,000 jobs in September also raised spirits on Wall

Street, where investors saw the first real evidence of a recovery in nearly a year as a sign of sustained momentum in the economy (chart). And the news was undoubtedly greeted with relief at the White House, which does not want the lack of new jobs to be a campaign issue in 2004. The net gain in payrolls last month was widely expected, with most economists looking for another step up. Nevertheless, the details of the report, from the slowness of job increases to the smallest losses in the long-suffering manufacturing sector in more than a year, strongly suggest that the jobless recovery is coming to an end. That notion is also supported by growing evidence that overall demand by consumers and businesses is now feeding into a higher gear.

But the next step in the job revival will be the most difficult. Hiring must now rise to a pace that will assure a self-sustaining economic expansion, where new jobs generate demand that encourages businesses to expand, creating even more hiring. On that front, the data are not so encouraging.

WHAT'S BECAUSE STRUCTURAL changes within the labor markets will make it harder for job creation to pick up strongly, even if real gross domestic product grows at a solid clip. Companies face unusually intense cost pressures that were rare or nonexistent in prior upturns. Global competition, soaring health-care expenses, and the need to restore pension fund assets are eating away at profit margins at the same time that businesses have little pricing power in a low-inflation economy.

In response, businesses have rethought the way they manage their workforce to get more output from less labor. The result has been improved margins, but also a more pernicious "jobless recovery" than the one following the 1980-91 recession.

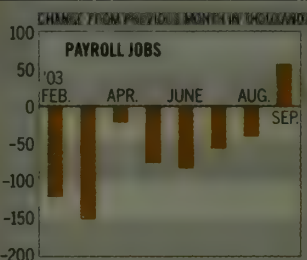
Economists at the Federal Reserve Bank of Kansas City examined how businesses rely on flexible labor inputs to adjust their payrolls with production. They say that temp workers, part-time employees, and work-time management have allowed companies to delay hiring full-time workers. They also note that a greater number of job losses in this business cycle are permanent. In addition, companies are using technological

advances to keep productivity growing. Little wonder, then, that even with the September job gain, payrolls are down by more than a million since this recovery began.

In the long run, faster productivity growth is undeniably positive. But in the coming year, companies' continued reliance on efficiency will work against a rapid return to strong hiring. Suppose real GDP grows

at a healthy 4% pace. That growth must come from some combination of productivity gains and additional labor. For job growth to pick up to a normal recovery pace of greater than 200,000 per month, or about a 2% rise, productivity growth, which has averaged 4.5% in this recovery, will have to slow to less than 2%.

THE JOB MARKET IS FINALLY TURNING AROUND



Data: Labor Dept., Global Insight Inc.

True, productivity always slows as a recovery matures. But since companies see efficiency gains as the primary way to remain competitive and profitable, they aren't likely to allow productivity growth to slide that much. The upshot: Hiring will trail the pace after the 1990-91 recession. By the third year of that upturn, job growth averaged 268,000 per month. This recovery begins its third year in November, and payrolls look on track to grow only about 100,000 per month well into 2004.

BUT THE GOOD NEWS is that September job data show businesses are finally lifting payrolls again. In addition to the top-line job gain, 47% of private industries increased payrolls, the most in 2½ years. Temp workers, who tend to be hired before businesses commit to permanent workers, increased by 33,000, the fifth advance in a row.

Even the beleaguered manufacturing sector looked less awful. The loss of 29,000 factory jobs last month was the smallest in over a year. And the factory workweek lengthened by 12 minutes, to 40.4 hours, suggesting a gain in September factory output.

Even so, hiring over the next few months won't be

strong enough to bring September's 6.1% unemployment rate down. Payroll gains have to average about 150,000 per month for a sustained period in order to absorb the new entrants into the labor force, which will only hold the jobless rate steady.

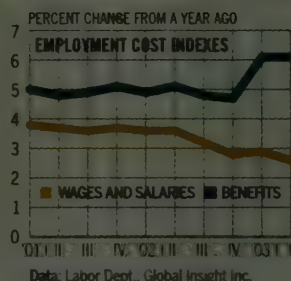
If anything, unemployment might go higher. Faced with few job prospects, people have dropped out of the labor market. In September, the labor force participation rate—the percentage of the population either working or seeking work—fell to a 12-year low. But in the early stage of faster economic growth, more people tend to reenter the labor force looking for work, often unsuccessfully. The increase in job seekers may cause the jobless rate to rise at some point in the fourth or first quarters. The rate will eventually fall, but whether the drop will come fast enough to satisfy the White House remains to be seen.

ONE SURE THING is that companies will remain focused on reining in payroll costs. In the year ended in the second quarter, labor expenses grew 3.6%, almost equal to the 4% increase in revenues economywide, as measured by the dollar value of GDP.

Amid slack labor markets, companies have squeezed down the growth of wages and salaries, from 3.8% per year at the start of the recession to 2.6% in the second quarter. But over the same period, benefit costs have accelerated from 5% to 6.1% currently (chart). The jump mainly reflects the double-digit pace of health-care programs, which are forecast to rise 12% in 2004 (page 42).

On top of that, companies are dealing with huge pension fund losses as a result of the stock-market downturn and low interest rates. Fed Governor Susan Schmidt Bies noted on Oct. 8 that by the end of 2002, 90% of the defined-benefit plans of the Standard & Poor 500 companies were underfunded by \$200 billion.

BENEFITS KEEP PRESSURE ON LABOR COSTS



Despite these impending bills, the success businesses have had in cutting payrolls and holding the line on wage gains means labor's share of national income continues to fall this year as profits' share keeps rising. This widening gap sets up a clash between the desires of the labor force and the investor class. Workers want bigger pay raises and job seekers want to see more hiring. Investors want businesses to concentrate on pumping up the bottom line and lifting stock prices.

History has shown that both can be satisfied, but only if demand growth accelerates to a point that enables the economy to accommodate both its productivity trend and the desires of job seekers. The positive surprise in the September data indicates businesses are starting to hire again. But in this upturn, don't expect a sharp turnaround in the job markets to happen overnight. ■

ITALY

Trying to Ease the Pension Squeeze

IS ITALY GETTING serious about pension reform? Prime Minister Silvio Berlusconi has made it the focal point of his 2004 budget, even taking the unusual move of going on national television to plead his case. Berlusconi appears ready to go head to head with the unions, but he also faces opposition within his coalition government, especially from the Northern League party.

Beginning in 2008, Berlusconi's plan would require all workers to amass 40 years of pension contributions, up from 35 years, with penalties for early retirement. From 2004 to 2007, as an inducement to delay retirement, the plan would pay workers eligible to retire under

existing rules a bonus of 32.7% of their salary, equivalent to the contributions they and their employers would continue to pay into the system. Unions, which are receptive to the work incentives but opposed to a longer contribution period and penalties, have set an Oct. 24 strike date to protest the proposal.

The driving force for reform is the growing financial reality of Italy's public debt, now totaling 106% of gross domestic product, which is draining private-sector funds and limiting tax and spending measures that could lift economic growth. The government is spending 5.7% of GDP—more than 70 billion euros (\$80 billion)—per year just

to pay interest, and the government's latest projections imply debt service above 5% through 2007.

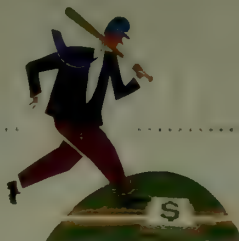
The country's pension economic will start to deteriorate rapidly in coming years, as baby boomers begin to retire. Plus, Italy's low birth rate will leave precious few workers to support the new retirees. "The only option on the menu is a structural and sustainable reduction in pension spending," notes Vincenzo Guzzo of Morgan Stanley's London office.

Italy fell into recession in the first half of 2003, increasing pressure on government finances. The 2004 budget offers 16 billion euros in deficit cuts, few of which are either structural or sustainable. The measures should trim the budget deficit from 2.5% of GDP this year to 2.2% next year, keeping it safely within the 3% euro zone limit. But these relatively painless measures may be aimed at easing the way for more painful pension cuts.

ITALY'S BUDGET ASSUMPTIONS

	2003	2004	2005
REAL GDP	0.5%	1.9%	2.2%
INFLATION	2.6	2.0	1.5
UNEMPLOYMENT	8.7	8.4	8.1
DEFICIT*	2.5	2.2	1.3
TOTAL DEBT*	106.0	105.0	103.0

*PERCENT OF GDP
Data: Bloomberg Financial Markets



Steve Galbraith, Morgan Stanley Chief Investment Officer

Searching for financial walks & stolen bases.

Michael Lewis' latest book, *Moneyball*, is all about finding value where the consensus does not. The book revolves around the unlikely success of the Oakland A's, who, in finance terms, consistently outperform the market with players (stocks) that other teams (investors) deem rejects. The A's managers found that convention tended to overrate such sexy achievements as stolen bases and batting averages while underestimating the importance of on-base percentages and walks. Which led us to wonder: What are the financial equivalents of a stolen base and a walk?



Growth rates — the financial equivalents of a .280 hitter with a .290 on-base percentage. The A's found that "bad" body types can still be terrific players, and vice versa. Too often scouts predetermine that the 6'3" beefcake boy will outperform the dumpy 5'8" guy. The financial equivalents of the 6'3" stud who can't hit a curve ball are "growth" factors like historical and forecast growth rates. If one were systematically to buy the quintile of stocks offering the fastest historical or projected growth while shorting those providing the least, an investor would systematically underperform the market by some 500 basis points per annum.

Say No to Mo'. What's an even more obvious way of underperforming? How about buying a stock that has just gone up a lot. Buying yesterday's winners is akin to being caught stealing a base. If one were to systematically go long the quintile of stocks with the best performance over the prior month while going short the quintile with the worst, one would systematically lose a lot of money.

The walk equivalent. The most prominent characteristic the A's look for in players is the ability to draw walks. Walks are highly valued both for what they are not (i.e., outs), and what they are (an active use of the opposing pitcher's arm, and a place on the bases). Walks = success. But walks are boring. Walks do not elicit oohs. As such, walks are grossly undervalued. In the stock market, we have endured an era where investors chased the oohs and aahs, overlooking boring old valuation. Over the long haul, the most important factors in adding alpha to portfolios are valuation oriented. Price to earnings, price to sales and even price to book are the financial equivalents of walks. If one were to buy systematically the cheapest quintile of stocks on these metrics while selling short the dearest, one might enjoy an early retirement.



Sizzle is vastly overrated. Just as being a Red Sox fan prepares one much better for the realities of life than being a Yankees fan, understanding the nuances of baseball can help you understand investing. In an era characterized by corked bats and corked financial statements, give us the steak, not the sizzle, give us walks, give us cheap stocks.

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CALIFORNIA

SOMETHING'S GOT TO GIVE

Arnold must cut electric rates, woo business, squeeze the special-interest bloat out of the budget, and soothe political wounds. Whew!

IN THE END IT WAS LESS A political campaign than a promotional tour for a superstar's latest flick. Criss-crossing the state in a white Learjet, setting down for 15-minute photo ops, actor Arnold Schwarzenegger tossed out scripted one-liners with the charm of a pitchman before heaving "Join Arnold" T-shirts to adoring throngs. And at most stops, there were props to make his point. In San Diego, he brandished a "broom" to symbolize his intention to sweep Sacramento clean of cronyism and gridlock. In Costa Mesa, a wrecking ball fell from a five-story crane to smash a beat-up Buick, symbolizing how Schwarzenegger intended to pulverize the tripling of auto taxes that Gray Davis approved as the movement to recall him intensified.

To get elected, Schwarzenegger shrewdly tapped into the well-known voter resentment of a state that's battered and broken, governed by a balkanized and dysfunctional political system. Now, as the 56-year-old bodybuilder transitions to Conan the Governor, promo stunts will need to give way to forging policies and the nuts and bolts of political dealmaking to try to implement them. Electric rates are among the highest in the nation, as are the regulatory burdens and costs of doing business. Indeed, runaway premium hikes for workers' compensation threaten to send businesses out of state.

California's fundamental problem, though, is its structural budget deficit, which could top \$8 billion next year. The budget has been larded by years of spe-

cial-interest gimmes and look-the-other-way hikes. "What we have to do is open up the books, do the audit, and find where the waste is," pledged the governor-elect at his first press conference on Oct. 8. The core reason for the deficit seems tractable—and one that clearly did Schwarzenegger's predecessor: a ballot initiative system that lets voters mandate spending with a 50% majority and a strict constitution that requires the legislature to pass taxes with a two-thirds vote. Schwarzenegger is to succeed, he'll have to tackle the ballot-and-budget morass head on. And he'll have to close the budget deficit by cutting Ronald Reagan-style deals with a Democratic legislature, which could force him to back off from several of his campaign promises.

Can he do it? Schwarzenegger, v

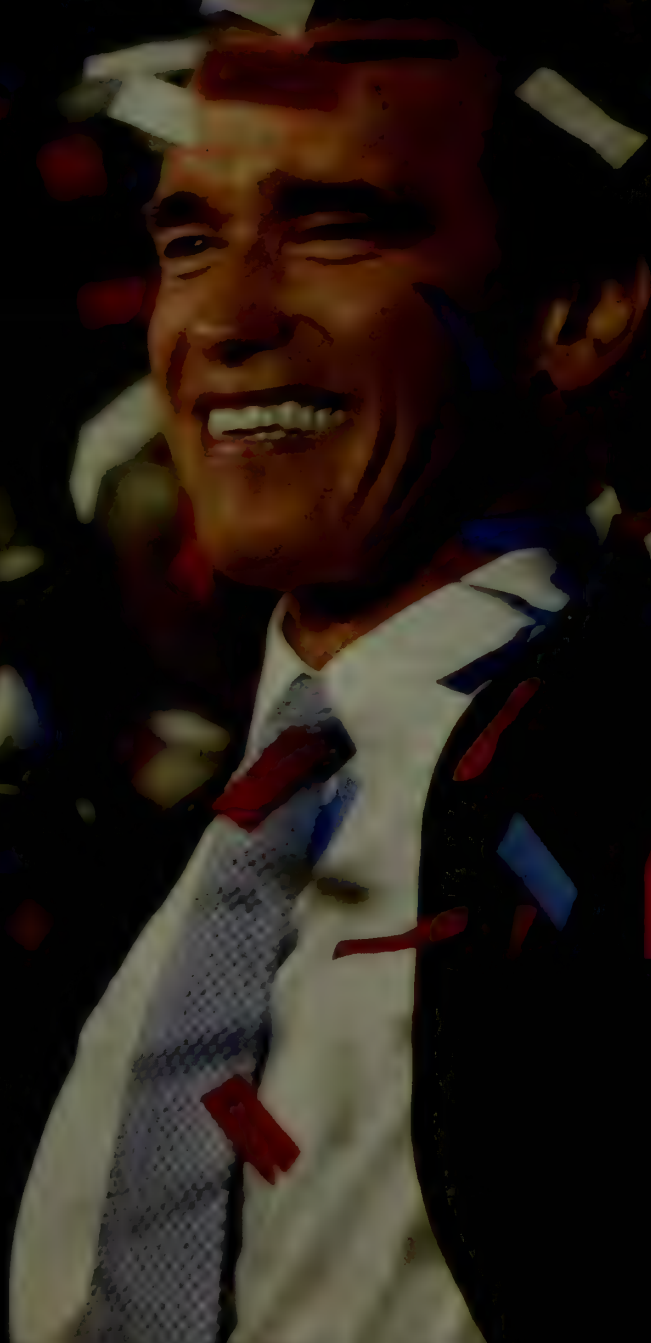
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“

What we have to do is open up the books, do the audit, and find out what the waste is”

takes over in mid-November, has only 75 days to put together a budget plan that has eluded Davis and the legislature. Edward E. Leamer of the University of California at Los Angeles, who sat on Schwarzenegger's 18-person economic-development team, says he recommended raising taxes and freezing spending for three years. The goal: to persuade bond agencies to raise the state's credit ratings and help save \$1 billion in interest.

RIPE FOR THE AX

DOING SO, HOWEVER, would require the new governor to ditch his campaign promise of no new taxes. So first he'll likely look for savings by trying to roll back salary and pension hikes for such politically powerful groups such as prison guards, which donated generously to both Davis and legislators. And he can cut deeper into the state's 200,000-person workforce, getting more than the \$1.1 billion the legislature got this summer by cutting the personnel budget 10% and ending redundant state offices such as the Office of Managed Care.

It would take an enormous political fight—and equally strong political skills—to get there, but former State Controller Kathleen Connell estimates that Schwarzenegger could cut billions from the state budget through such measures.

Beyond healing the budget, an equally critical task will be reassuring a jittery business community that California can again offer an environment in which corporations can thrive. "In no regard can California be seen as favorable to business," says Ross C. DeVol, director of regional studies at the Milken Institute, a think tank that estimates the costs of doing business in California at 28% higher than the national average, behind only Massachusetts and New York. Indeed, in an open letter published in newspapers

CALIFORNIA AT THE CROSSROADS



One Costly Place to Do Business

WORKERS' COMPENSATION

\$5.23 per \$100 of coverage, more than twice the national average

ELECTRICITY RATES

\$11.54 per kilowatt hour, 60% above the national average

MINIMUM WAGE

\$6.75, 31% above the federal minimum

CORPORATE TAXES

Ranked 49th in the nation for overall business-tax climate

OVERALL COSTS

28% above the national average*

*Includes taxes, wages, electricity, and real estate costs.

Data: Los Angeles County Economic Development Corp., Insurance Information Network of California, U.S. Energy Dept., U.S. Labor Dept., Milken Institute

across the state on Sept. 22, business heavyweights including Intel CEO Craig R. Barrett, Hewlett-Packard CEO Carleton S. Fiorina, and Charles Schwab CEO David S. Pottruck urged California's top officials to take steps to mend the state's economy and prevent more businesses from fleeing. Among their pleas: no new taxes, no new burdensome regulations, and an end to 11th-hour

BUSINESS PLEA

High-profile execs placed this ad in California newspapers

legislative surprises. They'll be watching Schwarzenegger closely. For the business community, the issue is more pressing than the out-of-control work comp system, which requires California companies to pay \$5.23 for each \$100 payroll. That's tops in the nation, according to the Oregon Consumer Business Services Dept., and roughly 60% higher than states such as Texas and Nevada that regularly steal California companies. "California is not much a competitor as a hunting ground," quips Texas Governor Rick Perry, who says he increasingly gets calls from high-tech executives such as Hewlett-Packard Co. is moving 500 jobs to Houston from a Roseville (Calif.) plant. Perry says he expects more such calls.

"LOONY-BIN" ATTITUDE

FIXING WORKERS' COMP will be no simple task. Costs are sky-high because the politically popular program includes a medical plan that allows extended treatment for things like chiropractic care and permits steep legal awards for pain and suffering. "It's a loony-bin kind of attitude," says John Lawrence, owner of 269-person Lawrence Equipment. His rates have skyrocketed to \$364,000 a year, leaving him contemplating a move to Arizona.

But even if the new gang goes nowhere on workers' comp, there are several other important and more easily achievable steps they could take. Lawmakers, halting a planned rise in unemployment contributions from employers scheduled to go into effect next year would help. Many companies would also like to see the retention of the Manufacturers Investment Tax Credit, which is set to expire at yearend. The likely

Dark Clouds Over the Golden State

THE BUDGET DEFICIT

What's Needed With at least an \$8 billion shortfall, the governor-elect will have to slash spending and raise revenues.

What's Likely Schwarzenegger won't win his campaign pledge to roll back the auto-fee hike. He could make some gains in cutting state employee pensions. A big fight looms on casino taxes, but Arnold could notch a victory there.

THE BUSINESS CLIMATE

What's Needed Businesses complain about some of the highest costs and regulatory burdens in the country. The workers'-comp system could use an overhaul, and new overtime, family leave, and health-care laws must be scaled back.

What's Likely Arnold could cut a deal on workers' comp and jobless insurance, but he'll likely lose on trimming other worker benefits.

DYSFUNCTIONAL GOVERNMENT

What's Needed The ballot initiative system that allows voters to mandate new spending while the Legislature's ability to raise taxes is limited. Effective statewide campaign-finance reform would also reduce interest deals.

What's Likely Voters aren't giving up ballot initiatives, but campaign reform has more

that tax credit is one reason the 565-watterson computer maker Wyse Technology Inc. is moving, says CEO John Hinger. Wyse has already set up plants in Texas and Taiwan.

LUMP CARD

THE ENERGY MESS Schwarzenegger inherits will also keep his hands full. Nothing demonstrated California's array more than whole swaths of the state going dark in the winter of 2001. The crisis left California saddled with costly long-term contracts that have kept energy costs well above the national norm. Schwarzenegger will have to renegotiate those contracts, a step that eluded Davis. He has a strong card to play: Some of those same power producers want to build plants in the state. The new governor should insist that the quid pro quo for new plants is a return to the bargaining table.

Sticking to his no-new-taxes pledge will be another matter. Made during the heat of the campaign to win over the Right, it won't play in Sacramento, where Jean Ross, chairman of the non-partisan California Budget Project. He estimates two-thirds of the budget is already earmarked by ballot initiatives for things like education and health care. Likewise, a promise to deep-six the auto-tax hike could also fall by the wayside.

That may not be the end of the world for Arnold: Ronald Reagan got to the statehouse on a no-new-tax pledge, but he ended up accepting a tax hike. But Governor Schwarzenegger is going to succeed, he'll have to be as deft at cutting out of real-world jams as his movie-bound characters are in the movies. ■

—By Ronald Grover and Christopher Palmeri in Los Angeles, with Ben Elgin in San Mateo, Calif., and bureau reports

ON AUGH NT Y COSTS

Needed California needs to encourage construction and get out from under long-term energy contracts. Plant should be linked to the renegotiation of contracts and new power producers into the state.

likely Further contract concessions may be won, but even if new plants come onstream, consumers will still be stuck paying debts for years from the 2000-2001 crisis.

COMMENTARY

BY RICHARD S. DUNHAM AND LEE WALCZAK

As California Goes, So Goes the Nation?

The recall reveals voter anger far beyond state lines

GRAY DAVIS WAS THE ONLY politician who lost his job on Oct. 7 in the cannibalistic spectacle that was the California recall election. But other officials are nervously sifting the results. Mindful that the Golden State is a trendsetter, pols wonder if the ouster of a governor just nine months into his second term is an isolated event—or something more: a sweeping revolt against incumbents nationwide.



Davis' defeat to a celebrity outsider shows that Californians are fed up with gyrating energy prices, perpetual budget crises, deteriorating schools, and infighting in Sacramento. But the intensity of the groundswell should send fear through the political class from coast to coast. It was the same kind of grassroots outrage that sparked the Proposition 13 property-tax revolt in 1978 and gave rise to the political cult of personality known as Reaganism at roughly the same time. "California has a history of angry, populist voters," says Andy Hernandez, a political scientist at St. Mary's University in San Antonio. "They had an outlet for that anger in the recall."

But the implications of Davis' defeat resonate far beyond the state's borders. California isn't the only state where politicians elevate partisan bloodletting above compromise, where special

TOTAL RECALL
Once again, voters are looking outside the system for leadership

interests and big money dominate the legislative process, and where the kitchen-table concerns of average citizens get brushed aside. "There

is a great deal of voter anger and cynicism," says Democratic media consultant Jim Duffy. "Most politicians these days are seen as role models for garbage collectors and thieves."

And at a time when incumbency rates for members of Congress top 95%, governors have borne the brunt of the wrath. In 2002, half of the statehouses changed hands. "Governors are in a very difficult spot," says American University political scientist James A. Thurber. "The buck stops with them."

But are the woes of governors, who are saddled by balanced-budget

requirements and are often on the firing line during hard times, indicative of a broader rebellion against elected officials and special-interest politics? So far, no—but that could change. The last time a broad anti-incumbent wave swept the country was 1994, when the GOP took control of Congress for the first time in four decades. In the post-September 11 era, voters seemed to flock to candidates with government experience. But the jobless economic recovery—and the harsh partisan headbanging in state capitals—has them looking outside the system again for leaders. “Anti-incumbent sentiment is brewing,” says Claremont McKenna College political scientist John J. Pitney Jr. “The challenge

The jobless recovery has voters scanning the horizon

for politicians is to harness the anger.” That’s exactly what Arnold Schwarzenegger did in a campaign that stressed bipartisanship and appeals for political reform—without dwelling on the messy details of governing. And Schwarzenegger has company out on the national campaign trail. It’s no coincidence that two leading candidates in the 2004 Democratic Presidential race are self-styled outsiders who assert that Washington has failed the leadership test. Retired General Wesley K. Clark is making appeals to independents and Republicans, and former Vermont Governor Howard Dean styles himself as a populist warrior who will seize the levers of power from entrenched interests. “People are concerned about whether the government works for them or not,” says Thurber. It’s at times like this that “outsiders are attractive.”

Many Establishment pols will scoff at the notion that figures as different as Schwarzenegger, Dean, and Clark have anything in common. Liberals are spinning the California earthquake as a personal rejection, and conservatives are equally insistent that it was a condemnation of tax-and-spend doctrine. There is a grain of truth in both claims, but in reality, Establishment types never see the Big Wave coming. The message of California is that politicians need to clean up their acts as well as their balance sheets—unless they, too, want to risk termination. ■

EMPLOYMENT

High Tech: A Little Help Wanted

During the tech boom, Jay Weidner typically received three calls a week from recruiters trying to pry him out of his job as a consulting project manager for software maker **Siebel Systems Inc.** The calls stopped when tech went bust—a good two years ago. But a funny thing happened a few months back. “The headhunters started calling again. Not like they were, but two or three times per month,” says Weidner, who started a new job in mid-September with **RightNow Technologies Inc.**, a Bozeman (Mont.) startup that delivers call-center software as a service over the Net. “It was a good sign.”

How good? It depends on what part of the tech industry you’re talking about. With startups and small companies—the likes of **Salesforce Inc.** and **RightNow**—beginning to recruit again, and layoffs coming at a far slower rate than earlier this year, some economists are starting to venture that the long slide in tech employment finally seems to be leveling off. “It’s still very early in the game,” says Joshua Feinman, chief economist at Deutsche Asset Management in New York. “But obviously, it’s encouraging.”

Elsewhere, though, the days of wine and roses have hardly returned. Many big tech manufacturers such as **Hewlett-Packard Co.** and **Sun Microsystems Inc.** continue to lay people off. As a result, the total number of people employed in the industry shrank by 0.1% last month, to 3.59 million.

Still, tech industry watchers are cautiously optimistic for two reasons. First, they cite the recent uptick in corporate spending on technology. Michael Englund, chief economist at consultant MMS International, estimates that spending on computers and electronic equipment grew at an annual rate of 15% to 20% in the third quarter, and will grow at the same rate in the fourth quarter. “With demand

is going to come employment,” he says.

Moreover, industry analysts note that startups, not industry giants, are typically the engines of tech job creation. In the 1990s, existing companies in Silicon Valley actually cut 121,000 jobs, while companies started after 1990 created 259,000 jobs, according to the Public Policy Institute of California.

That pattern seems to be repeating itself. Small tech firms are staffing up, especially software and computer systems design outfits. **Salesforce Inc.**, a San Francisco company that rents software over the Internet, has doubled its workforce, to 400, this year and is expected to double it again next year. Companies such as **Google**, **Intuit**, and **Symantec** kept hiring right through the slowdown—and are picking up the pace.

Another positive indicator: Companies

are hiring more temporary workers, often the first step before a boost in permanent hires. “We have had more orders sent our way in the last couple of months than we have for the last 18 months,” says Priscilla Azcueta, vice-president for business solutions at **Manpower Inc.**’s Silicon Valley franchise. Overall revenue for the franchise is up 30% so far this year over 2002 as temps get work doing everything from inventory planning to mechanical engineering. “There’s been such a depletion of resources” at some companies that they can’t handle new business

without hiring people, she says.

Of course, there’s no guarantee the hiring will last. Computer design firms boosted payrolls last fall, then cut jobs when demand didn’t materialize in the spring. But as Weidner notes, he wouldn’t have left Siebel were it not for five offers at smaller outfits—prospects that weren’t there a year ago. ■

—By Jim Kerstetter in San Mateo, Calif., and Peter Coy in New York

THE STATS

Computer systems design companies boosted hiring by **0.2%** from August to September. Employment has **Bottomed Out** at software publishers, storage device makers, and at Internet service providers and Web search portals.



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Goodbye, headaches.



HEALTH CARE

GET USED TO THE PAIN

Another round of double-digit hikes in health-care costs is in the mail.

DURING THE BEAR market, many investors allowed their mutual-fund statements to pile up unopened rather than face the music. These days, as the season for enrolling in employer health plans kicks into high gear, millions of Americans are feeling equally queasy about another ominous envelope: the one bearing the bad news about their company's health plan.

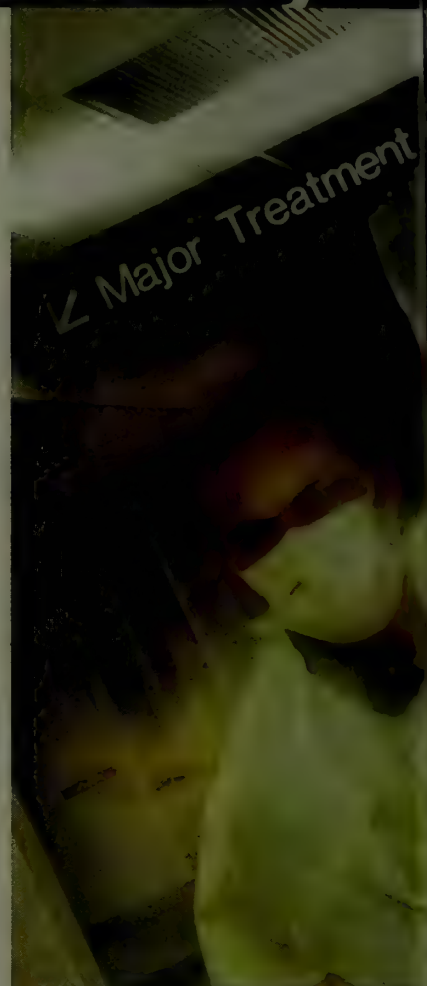
With good reason. On average, health insurance costs for employers are expected to soar 16% this year. Although next year the surge will slow a bit, to 12%, according to a study released on Sept. 29 by benefits consultants Towers Perrin, it will mark the fifth straight year of double-digit increases. As a result, businesses are increasingly opting to share the burden with their employees in ways that make them more aware of the true cost of health care. "One reason that health-care costs are out of control is that employees regard health care as free," says George David, chief executive of United Technologies Corp. To break that perception, UTC requires workers to pick up 30% of the cost of using in-network services, and 40% for out-of-network, until costs reach caps as high as \$10,000.

Even for workers at companies taking more conventional approaches, costs are skyrocketing. Although most large companies still pay the same share of health insurance premiums as they did several years ago, the average

premium workers shell out for family coverage has jumped nearly 50% over three years, to \$201 a month, according to the Kaiser Family Foundation. Deductibles and copayments for buying drugs are up far more sharply, while more companies are tacking on nasty new charges, like separate deductibles for hospital admissions. And many small businesses are instituting far more draconian cuts, or dropping coverage altogether—one reason why the number of uninsured Americans reached a record 43.6 million last year, up 2.4 million in just one year.

REFORM BATTLE AHEAD?

ALL THAT, IN AN ERA when wages and incomes are barely rising, has left many a worker increasingly squeezed. The extent and duration of escalating health-care costs have many experts predicting that a new battle over reforming the health-care system is on the horizon. It will almost certainly emerge as a major theme of the Presidential campaign. "This system is simply not sustainable," warns Sean Harrigan, president of the California Public



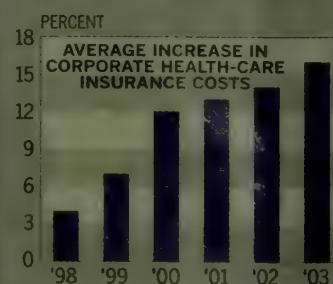
Employees Retirement System, which provides health benefits to more than 10 million people, making it the nation's third-largest purchaser of health care.

And double-digit increases in health care likely will continue through much of this decade. Blame that partly on graying boomers. The average age of employees covered by health-care plans is now 41, up from 38 in 2000. Because older workers use more health care, this pushes up the average age of a full four percentage points a year. Increased use of prescription drugs is another big culprit. So is greater demand for expensive tests and specialists.

Just as important, insurers also

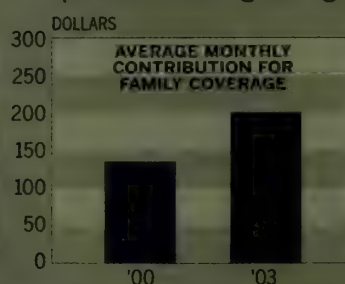
BE WELL—AND PAY UP

As health costs soar...

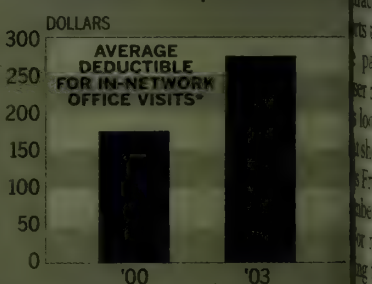


Data: Towers Perrin, Kaiser Family Foundation

...premiums are growing...



...as are out-of-pocket costs:



*PREFERRED PROVIDER ORGANIZATION



ing their muscles. After a brutal price in the late '90s, many have become focused on the bottom line. They tightening guidelines, shunning unprofitable markets, and, yes, raising rates. Health-care costs for fully self-insured companies are up just 12.4% this year, according to Kaiser. In contrast, premiums for companies buying insurance are up 15.6%. "It's a fabulous time to be an insurer," says Joe France, an analyst at Citicorp of America Securities. Take Aetna, which suffered an operating loss of \$6 million in 2001. With rates rising at a 6% annual clip, it expects to earn \$900 million in operating profits this year. No surprise then that employers are trying to regain some bargaining power. In receiving initial bids for a 31% hike this year, CalPERS negotiated a multiyear contract with Blue Shield and stepped up efforts to manage costly chronic diseases. The payoff: Premiums will rise 18%. France reports a stunning 62% of companies looked for a new provider last year. But shopping could begin to pay off, says France, since insurers "want to gain members after years of losing them." Or now, many big companies are rethinking the urge to burden workers with a larger share of premiums. This year, for example, the average worker will

shell out \$2,412 in premiums for family coverage. Although up 49% since 2000, that still represents just 27% of the total \$9,068 bill, the same share as in recent years. "Companies recognize this is a very sensitive issue," says Richard Ostuw, a principal at Towers Perrin.

Maybe so, but workers' out-of-pocket costs for using the health-care system are rising far more steeply than premiums. Since 2000, the average deductible for workers using in-network services in preferred-provider organization plans has jumped 57%, to \$275, Kaiser says, while the hit for using out-of-network services has soared 65%, to \$561. And 44% of companies now levy a separate deductible, averaging \$200, for each hospital admission, reports Kaiser.

Of course, much depends on where one works. Although Ford Motor Co. has trimmed health benefits for its white-collar workers twice since it launched its turnaround efforts in early 2002, it still picks up 90% of the total tab for its active and retired workforce. By contrast, hotelier Wyndham International Inc. scrapped a health maintenance or-

COSTLY CRISES Aging workers are driving prices

ganization plan that required no copayment, in favor of plans that require employees to pay 15% to 40% of the full

cost, up to a maximum of \$2,500 or more. "We needed to make [sure] people who use the plan really think about what service they are purchasing," says Dixie C. Sweeney, vice-president of compensation and benefits.

SMALL-BIZ SQUEEZE

SMALL BUSINESSES HAVE less wiggle room than their larger counterparts. Sandra Hord, vice-president of Premier Insurance Brokerage Ltd. in Itasca, Ill., says she's seeing the most dramatic overhaul of health benefit planning in 30 years among her small-business clients. When it comes to covering workers, she says, "it's getting dangerously close to the time for companies to say, 'I just can't do it anymore.'" Just 65% of companies with 3 to 199 workers offered health coverage this year, down from 71% in 1999, even as 98% of those firms with more than 200 workers continue to provide coverage.

As companies large and small wrestle with rising health-care premiums, some insurers are stepping into the breach—offering cut-price plans. To help hard-pressed small businesses keep coverage, Wellpoint Health Networks has rolled out a broader range of plans, starting as low as about \$100 a month. For that, workers get insurance that covers 80% of the cost of catastrophic care and prescription-drug coverage—but nothing toward office visits. Some 18 major employers, including Wells Fargo & Co. and Lockheed Martin Corp., have signed up for PacifiCare

Health Systems Inc.'s new Value Network, which encourages employees to use high-quality but less expensive doctors and hospitals. The savings: 8% to 14%.

Still, many doubt such initiatives will solve the problem. That's why the 2004 Presidential election could echo 1992, at least on the issue of health care. That was the last time there was a spate of double-digit in-

creases in health costs. Back then, the debate over health care helped Bill Clinton win the White House. The way costs are rising, the issue could be as potent in '04. ■

—By William C. Symonds in Boston, with Brian Grow in Chicago, Carol Marie Cropper in Atlanta, Diane Brady in New York, and bureau reports

Employers hope to regain some bargaining power from insurers

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HIGH TECH

WAS IBM HAZARDOUS TO WORKERS' HEALTH?

A lawsuit claims chemicals used in making chips and drives caused cancer

IN 1978, ALIDA HERNANDEZ PASSED out while working at IBM's disk-drive plant in San Jose, Calif. IBM doctors sent her home for six weeks to recover and treated her for the shingles and blisters she developed during her leave. Although she worked with many chemicals at the disk-drive facility, Hernandez says IBM executives insisted that working in the plant presented "no risk," an assertion the company continues to stress to this day.

In 1993, two years after retiring, Hernandez was diagnosed with breast cancer

and underwent a mastectomy. She later found out that IBM medical records showed her liver was enlarged in the 1970s, though she says the doctors had never told her that. An enlarged liver can be a sign of chemical poisoning, which can lead to cancer. "I feel betrayed," says Hernandez, now 73. "If I had been told the chemicals I was working with were making me sick, I'd have never worked for IBM."

Today, Hernandez is one of more than 250 people suing IBM because of what they allege are workplace-related health

"I FEEL BETRAYED"

Hernandez contends that IBM didn't tell her she had an enlarged liver

problems. The plaintiffs say repeated exposure to carcinogenic agents used to make chips and drives caused various cancers in hundreds

of workers, as well as birth defects about 40 families. The first lawsuit, originally filed five years ago by Hernandez and 40 others, goes to trial on Oct. 14 in San Jose.

The outcome may hinge, ironically enough, on IBM's own technological sophistication. As early as the 1970s, plaintiffs say, the computer company's doctors maintained detailed databases of workers' health-care information, including patient visits to company doctors and mortality rates. That data could become a linchpin for the plaintiffs' cases because of the heavy burden of proof for workplace-related health claims. Hernandez and others must prove not only that the chemicals used at IBM caused their cancer, but that IBM knew or must have known that workers were being affected by the chemicals. The databases could prove critical in addressing the second point, legal experts say. "Unless there is an alternative explanation as to why the increased incidence occurred, the database will be potentially troublesome," says D. Alan Rudlin, an attorney with law firm Hunton & Williams LLP and an expert on toxic tort litigation who is not involved in the case.

LACK OF EVIDENCE

IBM DENIES ANY wrongdoing. Attorneys for the company say there is no evidence linking chemicals from its plants with illnesses or abnormalities. IBM lawyers argue that cancer can be caused by many different factors, including genes and lifestyle. "We really don't believe there's any proof that these injuries were caused in the workplace," says Marcy Siskind, an IBM lawyer. "Unfortunately, cancer is a fact of life for a large percentage of the population." What's more, IBM says its computer databases were not capable of correlating chemical exposures with the health of its employees. On Sept. 30, IBM scored a small

Big Blue's Legal Woes

IBM could face hundreds of millions in damages

THE CASE

More than 250 former workers allege that chemicals used at IBM chip and disk-drive plants caused cancer and led to birth defects in their children. IBM says there is no evidence linking chemicals in the workplace with illnesses or abnormalities.

BURDEN OF PROOF

Plaintiffs must prove that specific exposures caused the injuries and that IBM knew or must have known about danger. But legal experts say IBM databases containing workers' medical records could prove critical in this case.

MONEY CAN'T WORK HARD IF THE PERSON BEHIND IT DOESN'T.



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tory: A Santa Clara County Court judge dismissed the suits of two plaintiffs for lack of evidence, though he did say testimony from medical experts "is sufficient to create a triable issue" for Hernandez.

One question underlying the trial will be how paternalistic IBM's culture really has been. Seeking to provide convenient health care for its workers, Big Blue created medical centers inside its plants and offices in California and elsewhere. When employees like Hernandez got sick, they could visit company physicians. The records those doctors kept will be central to the trial. Dr. Robert J. Harrison, a professor of medicine at the University of California at San Francisco and a paid expert for the plaintiffs, says the "signs and symptoms recorded by IBM in Ms. Hernandez' IBM medical chart on numerous occasions are classic manifestations of systemic chemical poisoning...long before [she was] diagnosed with cancer."

INCREDIBLE DETAIL

THE DATABASES OF IBM workers' medical histories were incredibly detailed. The company's ECHOES system—short for Environmental, Chemical & Occupational Evaluation System—comprised two databases. One tracked the substances that IBM used to build and maintain its products, including medical data measuring effects of overexposure to toxic chemicals. The other contained massive amounts of employee information, such as substances that employees used on the job as well as work and medical histories. A separate IBM system included a mortality file with death certificates of more than 30,000 IBM workers who died between 1969 and 2000. Although the ECHOES system was detailed in a scientific journal in 1982, IBM says it was never used companywide. "Its rollout was ultimately unsuccessful," say company lawyers. Today, IBM says it uses ECHOES 2 to monitor air quality and chemical levels in its plants.

The plaintiffs argue that the databases were full of alarming statistics that even a routine analysis would have uncovered. Richard W. Clapp, a professor at Boston University School of Public Health and a paid expert witness for the plaintiffs, has reviewed the mortality file. In written testimony this September, Clapp says "IBM employees were dying disproportionately of cancer at a much younger age than people in the general population." He concludes in the testimony: "By 1975, IBM must have known their manufacturing employees have significantly increased deaths due to cancer and must have known throughout the next two decades."

This kind of evidence can have a potent effect on a jury, says Craig S. Bloomgarden, an attorney in Los Angeles with law firm Steefel, Levitt & Weiss who is not involved in the trial. "It can be used to corroborate the plaintiffs' claim that the exposure caused their injury," he says. IBM says the cancer rates among its employees have not been above average. "There's no evidence of abnormal cancer rates," says company spokesman Bill Hughes. "We have an extraordinarily strong health and safety record."

The plaintiffs also allege that IBM concealed its knowledge of the problems from the rank and file. Peter D. Lichty, an IBM doctor, said in a deposition that in 1987, IBM management was concerned that injury and illness rates in the San Jose plants were "higher than average." But the com-

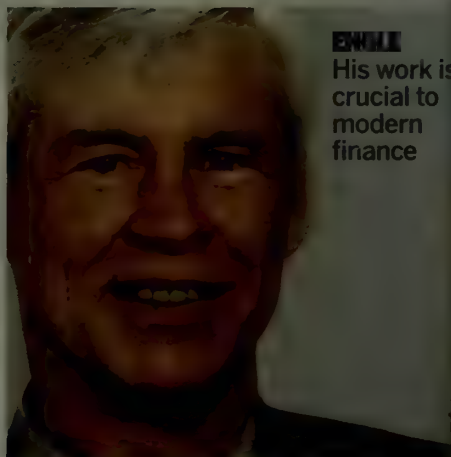
pany did not inform its workers of these concerns, say plaintiffs. IBM says it never concealed information from its workers.

Despite the wealth of detail in IBM file, victory is hardly assured for Hernandez and her co-workers. They must convince a jury beyond a reasonable doubt that the specific exposures caused the injuries. If they win, it could mean hundreds of millions of dollars in damages. For Hernandez, it's not only about the money. She is thankful to be alive 10 years after her battle with breast cancer. And she hopes the case raises awareness among other workers and spurs companies to be open with their employees. "I don't want anybody go through the hell I did," says Hernandez. Whether IBM was responsible is now up to the justice system. ■

—By Spencer E. Ante in New York



GRANGER
Provided new tools to macro-economists



ENGLE
His work is crucial to modern finance

ECONOMICS

NOBELISTS WITH 20/20 HINDSIGHT

Granger and Engle gave economists new glasses

TO SEE INTO THE FUTURE, economic and financial forecasters extrapolate from the past. So imagine their distress when, in 1974, Welsh-born economist Clive W.J. Granger showed that the statistical techniques forecasters were using to come up with patterns in historical data were simply wrong. "The reaction was chaos for a few years," recalls Princeton University econ-

omist Mark W. Watson. Forecasters, including those at the Federal Reserve, had to find new methods that would work.

Eventually it was Granger himself along with colleague Robert F. Engle who came up with the statistical techniques that are now used in areas as diverse as bank regulation, mortgage derivatives, and the pricing of stock options. It was for these techniques that Granger and Engle—who had neighboring offices at the University of California at Berkeley—

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but also the means to act fast and decisively on it.

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Diego for 25 years—were jointly awarded the Nobel prize in economics on Oct. 8. Granger, 69, a British citizen, retired from teaching earlier this year. Engle, 60, an American, moved from San Diego to New York University's Stern School of Business in 2000.

EASIER TO HANDLE

GRANGER AND ENGLE'S innovations go by such arcane names as "Granger causality" and "autoregressive conditional heteroskedasticity." Basically, though, they come up with improved ways of handling economic and financial variables such as interest rates and factory output.

Unlike tosses at a dartboard, these variables are somewhat predictable—if an interest rate is 4% one day, it won't be 11% the next. And their volatility varies. In the financial markets, for example, periods of extreme fluctuations are followed by periods of calm. Older statistical tools couldn't cope with those features.

Granger's work has been a boon to macroeconomists, while Engle's has been crucial to modern finance. For instance, the modern version of the Black-Scholes formula for pricing options—including stock options—incorporates

Building the plumbing of modern economics and finance

adjustments made possible by Engle's work, says Massachusetts Institute of Technology economist Andrew W. Lo. "Nobody," he says, "uses plain-vanilla Black-Scholes anymore."

Engle's work also underpins how financial firms calculate their "value at risk"—namely, the most money they stand a chance of losing over, say, the next week. The Basel Committee on Banking Supervision is moving toward requiring all of the world's banks to employ value-at-risk models to determine how much capital they need to keep on hand as a cushion.

Granger and Engle helped build what might be described as the statistical plumbing of modern economics and finance. It may not be glamorous, but as the Nobel committee recognized, it's indispensable. ■

—By Peter Coy in New York

INVESTIGATIONS

MUTUAL FUNDS FEEL THE HEAT

Did they feed information to hedge funds, brokers, and others?

IN THE MONTH SINCE ELIOT Spitzer aimed his cleanup crusade at improper trading in mutual funds, one crucial sector of the financial industry has escaped charges: mutual funds. The New York Attorney General has uncovered alleged wrongdoing by hedge funds, brokers, and traders—all vital cogs in the selling and administration of mutual funds. But the \$7 trillion industry, while tarred in the headlines, has largely escaped the charges that are wracking its customers and business partners.

Not for much longer. Enforcement officials say their wide-ranging probe is uncovering abuses that will soon go straight to the heart of the fund industry. Upcoming cases will show that mutual funds were active participants in two of the three major types of wrongdoing that investigators have brought to light.

That isn't all. *BusinessWeek* has learned the Securities & Exchange Commission has found that some mutual funds are selectively disclosing their portfolio holdings to hedge funds, which

then trade on the info. The agency, which has joined Spitzer's probe with brio, is considering bringing insider-trading charges against the funds involved.

Moreover, the SEC is mulling an aggressive legal strategy that could result in fraud charges against mutual funds for the practice known as market timing or the rapid trading of a fund. Since the probe began, securities lawyers have maintained that most funds would be insulated from such charges unless they isolated a stated policy banning rapid trades. But the agency will probably argue that even those who didn't explicitly ban such trades violated their fiduciary duties to other shareholders.

ENDANGERED SPECIES?

THE SPITZER-SEC HUNT, which has resulted in dozens of leading mutual-fund companies being hit with subpoenas, has turned up evidence that trading abuses are more widespread than originally thought, officials say. The legal fallout from the probe could even wipe out some smaller brokerage firms. "Whether

SPITZER

The AG cites evidence of widespread abuses

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[in] hedge funds, broker-dealers, trust companies, or mutual funds," Spitzer told *BusinessWeek*, "we're going to have to ensure that trading [cannot be permitted when it's] contrary to the interests of those whose benefit is supposed to be paramount."

The most potentially explosive new charge: The SEC has discovered some mutual funds have selectively disclosed portfolio holdings to hedge funds and other investors, a practice one official termed "nefarious." Current rules require funds to reveal what's in their portfolios twice annually. But when the SEC early this year proposed funds make quarterly disclosures, the industry fought back, saying that would allow hedge funds to divine their investment strategies—and trade the stocks needed to implement those strategies ahead of the mutual fund. Such front-running would boost the funds' costs by driving stock prices up or down before they could adjust their portfolios, the industry argued.

AFTER-HOURS TRADING

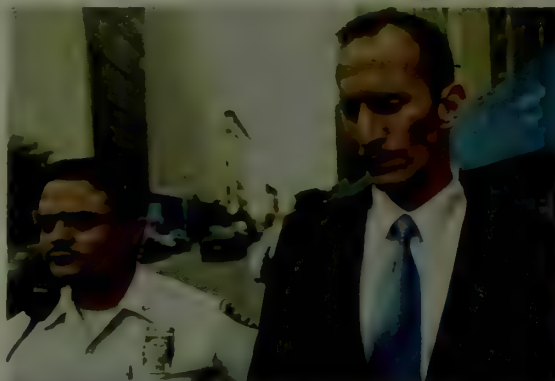
Turns out, an SEC official says, some funds have given hedge funds a sneak peek of their holdings—a green light to front-run. Enforcement Director Stephen M. Cutler, on Oct. 8 said the SEC is weighing insider-trading charges against those who allowed or engaged in such trades.

Still, the investigation has brought some good news for the industry. So far, the funds themselves don't appear to have been involved in late-day trading. Late trading occurs when a major investor, such as a hedge fund, illegally buys or sells mutual-fund shares after 4 p.m. at the price set when the market closed. By law, orders for fund shares entered after 4 p.m. should be priced at the next day's closing.

Spitzer's probe has shown that most late trading involves illicit deals among hedge funds, Wall Street brokers, and the transfer agents that handle funds' back-office paperwork after the 4 p.m. deadline. On Oct. 2, Steven B. Markovitz, a former trader at hedge fund Millennium Partners LP, pleaded guilty to criminal charges brought by Spitzer and settled civil charges by the SEC involving such late trades. Earlier, Spitzer and the SEC leveled similar charges against Bank of America broker Theodore C. Sihpol III, who pleaded not guilty. More such joint actions are expected in coming weeks.

That hardly leaves mutual funds unscathed. Spitzer and the SEC will probably bring civil charges against numerous funds for allowing market-timing—the moving of large amounts of money in and

out of a fund in short order. Timers can profit handsomely from short-term gaps between a fund's value and the prices of the stocks it holds. This is especially true for those with international stocks, which trade on exchanges that close up to 12 hours earlier than U.S. markets, making



Where the Investigation Might Lead

The ongoing probe of the mutual-fund industry is expected to widen dramatically in the weeks ahead

BROKERAGE FIRMS A Bank of America broker has been charged with improper trading of mutual-fund shares. Merrill Lynch and Prudential Securities have already fired numerous brokers, though they have not been charged.

HEDGE FUNDS Millennium Partners trader Steven B. Markovitz, who pleaded guilty to securities fraud, is the first of possibly many hedge-fund personnel to face criminal charges for late trading.

MUTUAL FUNDS Fund companies may have to return big money to investors for letting hedge funds rapidly trade mutual-fund shares. Some individuals may face criminal charges for after-hours trading.

their prices stale by the 4 p.m. New York close. The problem: Other shareholders get short shrift when funds sell off good investments or hold extra cash to pay back the timers. Shareholder returns also decline because market timing raises mutual funds' own trading costs. "For the most part, late-trading appears to be stopping at the [mutual funds'] shore," says a top SEC official, "but the timing stuff washes right up on the beach." The result is likely to be disgorgement of significant amounts of money as restitution, says one official.

More bad news: Industry leaders believe even if some funds were complicit in market timing, regulators will only go after funds that violated their own explicit policies. No, says an SEC source. The SEC is mulling bringing cases even when a fund hasn't banned market timing. The

SNARED Markovitz pleaded guilty to securities fraud

reasoning: Under the Investment Company Act of 1940, funds must treat all shareholders the same. If a fund adviser gives

preferred treatment to a big investor in exchange for a benefit, such as an extra fee, the fund is in conflict with other shareholders. That may violate the act's requirement that all shareholders receive equal treatment and that conflicts be fully disclosed.

NEW IMPETUS

EXPOSURE OF THESE wide-ranging abuses could slam the entire financial-services industry. Representative Richard H. Baker (R-La.), chairman of a House panel with jurisdiction over capital markets, plans to rewrite previously offered mutual-fund reform legislation. New revelations, he says, "have started a fresh discussion of what reforms are needed. The industry defense was 'we've done nothing wrong,' but it seems that's not so."

Other lawmakers may try to erect barriers between banking and investment services torn down in 1999. After all, many late-trading and market-timing problems take place at large, full-service Wall Street firms, where firewalls between the sales desks on the banking side and fund managers on the investment side have broken down in the race for higher commissions and fees. Already, close to a dozen brokers have been fired from such firms as Merrill Lynch, Citigroup, Prudential, and Bank of America.

Fund directors, too, are in the eye of the storm. Some critics insist that the governing mutual funds must be amended so that fund boards take more responsibility for the advisory companies that manage funds. Before it's all over, this topus-like probe is likely to reach far beyond the financial institutions directly caught in the dragnet. ■

—By Paula Dwyer in Washington and Emily Thornton, with Michael Der Hovanesian, in New York

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THE AUTO BIZ

IT'S BIG. IT'S BRAWNY. IT'S JAPANESE

As Nissan rolls out a full-size pickup, Detroit's last niche fades into history

BACK IN EARLY 2000, five Nissan auto designers fresh off the plane from Tokyo took to the highways and byways of Texas, where big pickup trucks are almost a religion. Outfitted with cowboy hats and boots, they stopped along the way to talk to ranchers, contractors, and other macho truck drivers. What they found is that Americans like their pickups big, very big, and loaded with creature comforts. The Nissan Motor Co. designers took careful notes.

Now comes the payoff. While General Motors Corp. and Ford Motor Co. go to the mat in what promises to be a nasty price war over their profitable pickups, the newly designed F-150 and the Chevrolet Silverado, the Japanese are swooping in for their piece of the \$48 billion U.S. pickup truck market. On Oct. 17, the first Nissan Titan rolls off the line at a new factory in Canton, Miss. Four days later, Toyota Motor Manufacturing North America Inc. will break ground outside San Antonio for its second U.S. truck plant.

NIFTY INNOVATIONS

IT'S SCANT COMFORT to the Big Three that the Japanese auto companies are late to the pickup market. The full-size pickup market has been one of the few lucrative segments Detroit has had almost to itself—until now. The Japanese are about to squeeze profits and hold Detroit to higher standards, just as they have done before with minivans and sport-utility vehicles.

The new Titan is a pickup even a Texas rancher could love. Yet Nissan is also betting the truck will appeal to weekend warriors toting jet skis, speed boats, or just hauling home a few sacks of mulch. It sports a powerful 300-horsepower V-8, serious towing capacity, and a spacious cab. And to avoid being just a me-too



NISSAN 2004
TITAN

Truck Wars: What They're Packing

CHEVY SILVERADO GM's powerful workhorse has gotten a recent facelift for a tougher, sportier look and offers four-wheel steering. \$19,665-\$36,360

FORD F-150 The new 2004 iteration boasts superior towing, a smoother ride, and a beefy grille that says, "Get out of my way." \$22,010-\$36,365

DODGE RAM Its big-rig styling pushes a macho image while the newly introduced Hemi V-8 pumps out top horsepower. \$20,215-\$36,395

TOYOTA TUNDRA Slightly smaller than domestic rivals, it has smooth handling and enough pep for suburban drivers. \$16,495-\$31,705

NISSAN TITAN The first Japanese pickup with enough size, horsepower, cab space, and towing capacity to take on U.S. rivals on their own terms. Not yet priced

Data: Consumer Reports, Edmunds.com

truck, Nissan is offering nifty innovations, including sliding dividers for the truck bed and a built-in toolbox.

Toyota Motor Corp., which made early gaffes in the U.S. pickup market, has plans to make its pickups bigger and tougher. Toyota has gradually increased both size and horsepower after launching its original small and underpowered T100 pickup in 1993 to the derision of

many truck owners. Its successor, Tundra, introduced in 1999, got big and added a V-8 engine, but is still smaller than American pickups.

IMAGE PROBLEMS

IN EARLY NOVEMBER, though, Toyota will begin selling a roomier "Double Cab" version of the Tundra. And Toyota executives make little secret of plans to make next-generation truck, which will arrive in 2006, as big and powerful as a Chevy or Ford. Says Jed Connelly, sales chief for Nissan North America Inc.: "Sooner or later Toyota is going to get it right."

Even if the new Japanese trucks are huge hits, they still pose a big problem

for Detroit. Nissan and Toyota together will add 250,000 trucks to the slow-growing U.S. truck market. Wholesale sales of full-size pickups now running around 1 million annually, stepped-up competition is sure to bring down prices. That will slice into fat pretax profits that currently average about \$10,000 per truck, before incentives, says Saul Rubenstein, auto analyst at UBS Warburg. As a result, Rubenstein expects "an all-out price war" in big pickups.

For now, the old Chevy Silverado looks venerable. Expect GM to compensate by revving the price war against Ford's revamped F-150. Though a popular seller, it costs \$1,500 more than predecessor to buy. DaimlerChrysler's Dodge Ram could be hurt worst of all. The 2003 Ram boasts a powerful Hemi V-8 engine but hasn't made many improvements. Despite rebates of \$2,500 to \$4,500, Ram sales fell in September after double-digit gains earlier this year.

Foreign-brand trucks still have image problems among the Big Three's tensely loyal customers. "To be a carter and buy a Japanese truck takes some *cojones*," says Larry Dominique, the Nissan manager who oversaw development of the Titan. But that's changing. At this fall, Detroit's last big profit base will never be the same. ■

—By Kathleen Kerwin in Detroit

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EDITED BY MONICA ROMAN

HEADLINER

STEVEN REINEMUND



PEPPING UP PEPSI

He may keep trim by running marathons, but **PepsiCo** Chairman and CEO Steven Reinemund knows how to fatten up a bottom line. On Oct. 7, Reinemund reported a "terrific" third quarter for the food and beverage giant. Thanks to 7% revenue growth from snacks and 16% sales growth on the international front, profits climbed 13%, to \$1.07 billion. New products helped total revenue move ahead 8.4%, to \$6.8 billion. And analysts say that since taking the helm in 2001, Reinemund has wisely put PepsiCo closer to being a friend rather than a foe of the health community with moves like switching its chips from oils containing trans-fats to more heart-healthy versions. The \$14 billion acquisition of **Quaker Oats** in 2001 also gives more balance to PepsiCo's reputation for sugar and fat. "He has put PepsiCo in a position to take advantage of consumers eating healthier," says Bryan Spillane of **Banc of America Securities**. The ex-Marine is whipping out a lot of costs, too. That's a menu investors seem to find appetizing.

—Diane Brady

A MOTOROLA SPIN-OFF

After resisting the move for years, **Motorola** plans to spin off its semiconductor business into a separate, publicly traded company. **Motorola** is expected to distribute a portion of semiconductor equity to shareholders over the next few months and then spin off the division some six to nine months later. Most analysts expect the chip unit's initial public offering to fetch from two to four times its \$5 billion in anticipated 2004 sales. Independence should help the semiconductor biz win new customers. But it will have to work hard to overcome the \$246 million in operating losses it suffered in the first half of 2003.

DUKE'S CHIEF DUCKS OUT



ANDERSON
Back home

Another energy executive heads for the exit: On Oct. 7, **Duke Energy** said CEO Richard Priory will step down in coming weeks. He'll cede the job to former **Duke** executive Paul Anderson, who most recently was CEO of Australia's **BHP Billiton**. Under Priory, the sleepy Charlotte (N.C.) power utility bet big on deregulation, spending billions to build power plants in the U.S. and abroad to supply power on the open market. But when

Enron's bankruptcy turned the energy boom into a bust, **Duke** began to buckle. While **Duke** says the change simply reflects the 57-year-old Priory's long desire to retire in his mid-50s, he has felt the heat: **Duke's** stock trades at half its 2001 price, and investors began to fear that a dividend cut was imminent. Anderson won't comment except to say: "I feel dividends are pretty important."

AUDITORS' NEW DRILL

The **Public Company Accounting Oversight Board** unveiled its first standards on Oct. 7, tentatively approving a proposal on how accountants should evaluate internal controls at public companies they audit. The 2002 Sarbanes-Oxley Act requires auditors to gauge corporate executives' assessment of internal controls—the checks and balances that are supposed to deter fraud. The board wants auditors to do start-to-finish "walk-throughs" of key transactions. Also controversial: Auditors would have to scrutinize the audit committee of the board of directors.

A COURT SAYS NO TO POWELL

Federal Communications Commission Chairman Michael Powell has suffered another setback. On Oct. 6, an appeals court in San Francisco threw a wrench in the FCC's plans to deregulate cable and DSL broadband services. The court disagreed with the FCC's proposal to classify cable broadband as an "information service" that receives minimal regulation. Instead, the court said two-way cable modems share

characteristics of highly regulated telecom services. The **FCC** is appealing, but the ruling is likely to put the agency's DSL initiative on hold. Powell's earlier deregulatory attempts have met with opposition from several quarters, including FCC members, the courts, and Congress.

ET CETERA...

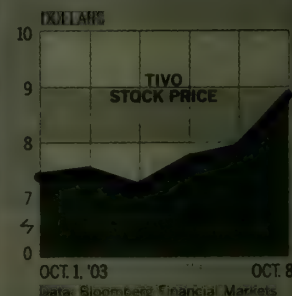
» Former **SEC** head Arthur Levitt and others joined an accounting think tank.

» **NBC** finalized its deal to buy **Vivendi Universal's** U.S. entertainment business.

» The **Atlanta** and **Pittsburgh** federal home-loan banks both reported losses for the third quarter.

CLOSING BELL

On Oct. 8, **TiVo** rose 11.8%, to 8.83, on news it will promote some **Fox TV** shows and that **DirecTV's** CEO will join its board. The move calmed fears that **News Corp.**, which is buying **DirecTV**, might end a deal to let users buy satellite set-top boxes with **TiVo's** video-recording service.



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Turning On the Tap For Wes Clark

HAS HAD BARELY A MONTH on the campaign stump, but Wesley Clark is giving his fellow Presidential contenders a run for their money. Already, he has enlisted some of the most prolific fund-raisers in the Democratic Party, including venture capitalist Alan J. Patricof, Wall Street financier Steve Rattner, and

Hollywood producer Norman Lear. The best evidence that the retired four-star general is more than a flash in the political pan: In two weeks as a candidate, Clark pulled in more than \$3.5 million. That's most as much as Missouri representative Dick Gephardt and Connecticut Senator Joseph I. Lieberman pulled in the past three months.

The scramble for cash is critical. With just 13 weeks before the first votes, the nine survivors of Primary '04 (Florida Senator Jeb Bush was voted off the island on Oct. 6) must show that they have the financial heft to take on President Bush. Former Vermont Governor Howard Dean led the pack with a whopping \$15 million take in the third quarter. But Clark is surging with the top of pragmatic Dems to think his chestful of medals, liberal social views, and centrist economics make him the party's best bet to topple Bush. A tightly organized fund-raiser, Lear's Los Angeles home netted \$300,000, including a check from California real estate billionaire Eli Broad. "People are thirsty to have a winner," Broad says. "None of the other candidates, capable as they are, have gotten people excited."

Coing Republicans

AT EXCITEMENT helped Clark raise about two-thirds of his \$3.5 million on the Internet—respectable, but not in the league as Dean, who has an online base of about 600,000 donors. Clark's list is all the more impressive when you consider that his rivals tapped the easy-to-

find contributors while the general was doing his Hamlet act. "Most people who donate have already made up their minds," says Silicon Valley tech exec Steve Kirsch, a Dean backer and major giver.

To compensate, Clark has assembled a squad of rainmakers that includes New Yorkers Sarah and Victor Kovner, Eli Pariser of MoveOn.org, Hyatt hotel scions J.B. and John Pritzker, *Rolling Stone* publisher Jann Wenner, and Bob Burkett, who in past elections helped raise money for Massachusetts Senator John F. Kerry.

Friends of Bill are rallying, too. They include Clinton Library head Skip Rutherford, Clark Campaign Chairman Eli Segal, and Patricof, who plans a \$1 million November gala in New York. "Clark will not fail because of an absence of resources," Segal vows.

The Clark Brigade will trumpet his military credentials and past support for Republicans to woo independents and GOPers. "Clark has

the capacity to reach beyond Democrats," says Simon Rosenberg, president of the centrist New Democratic Network. And Graham's exit could open spigots in moderate, pro-military Sunshine State. "Florida is extremely ripe for us," Burkett says.

Of course, cash gets you only so far. Clark's operation is still beset by turmoil: Campaign manager and former TechNet exec Donnie Fowler left abruptly on Oct. 7 after a dust-up with Segal. But if Clark can avoid any more major gaffes—and if the money keeps flowing—he could well emerge as the Stop-Dean candidate. ■

—By Lorraine Woellert



CLARK: He pulled in \$3.5 million in his first two weeks

CAMPAIGN 2004

THE GENERAL'S HEAVY HITTERS

DEMOCRATIC Presidential candidate Wes Clark has launched a fund-raising blitz with the help of key party moneymen. Among them are:

■ **Eli Broad**, who met the general through Clinton White House counselor Bruce Lindsey, now a Clark adviser. The philanthropist was scouting for someone to run the Los Angeles Unified School District, and Clark was a finalist. "He was very impressive," says Broad. "He's a centrist. He'll

have big backing from Democrats who are in business."

■ **Norman Lear**, who is defending Clark's beachhead in Hollywood. Days after Clark's entry, the longtime liberal activist wrote to 150 friends asking for donations. The result was a celebrity-studded Oct. 1 event at the producer's home, co-hosted by TV comic Larry David. Lara Bergthold, a Lear aide and a top Hollywood fund-raiser, will be thumbing through her Rolodex for the general. Other Celebs for Clark include Bette Midler, Jerry Seinfeld, and Michael J. Fox.

■ **Stanley S. Shuman**, executive vice-president of New York investment firm Allen & Co., who has crucial ties to Wall Street money. He and venture capitalist Alan J. Patricof, who was finance chairman of Hillary Rodham Clinton's 2000 Senate campaign, plan to tap New York's deep-pocketed business community. "The money is coming on a very broad-based basis, quite spontaneously," Shuman says.

Celebs for Clark: Jerry Seinfeld and Bette Midler

RUSSIA

MURKY DEALINGS IN THE OIL PATCH

Why is the Kremlin going after giant Yukos just when it may be on the verge of a megadeal with Exxon?

FRIDAY, OCT. 3, WASN'T A normal day at the Podmoskovny Lyceum, an orphanage outside Moscow. As bewildered children looked on, machine-gun-toting police surrounded the building while a team of government investigators combed through everything from computer records to children's exercise books in search of evidence of tax evasion by the institution's benefactor, oil giant Yukos. The same day, police raided other premises linked to Yukos.

Thus unfolded the latest chapter in the Yukos Affair, a tale of political and business intrigue that has gripped Corporate Russia for the past few months. The star in the drama: 40-year-old Yukos Chairman Mikhail B. Khodorkovsky. Kremlinologists say Khodorkovsky—a Communist youth leader turned banker turned oligarch—is being punished by the Kremlin for using his company to boost his political clout.

Kremlin pummels pesky oligarch: We've read this script before. But the Yukos story gets twisted fast. Consider that just a day earlier, Khodorkovsky and ExxonMobil Chairman Lee R. Raymond were rubbing elbows at a panel in Moscow organized by the World Economic Forum. The Financial Times reported that Exxon was offering Yukos \$25 billion for a 25% stake—a deal rumored since August. But neither side will acknowledge that a deal is in the works. ChevronTexaco Corp. is nosing around, too.

And what about Russian President Vladimir V. Putin, who supposedly wants Khodorkovsky taken down a few pegs?

He has publicly endorsed the idea of big foreign investment, leaving open for now the possibility of an ExxonMobil-Yukos deal—a deal that would net Khodorkovsky, already Russia's richest man, several billions. In a recent interview with *The New York Times*, Putin signalled that he would welcome a major investment in Yukos by Exxon.

ATTRACTIVE RESERVES

IT'S A RIDDLE WRAPPED in a mystery inside an enigma, to borrow from Winston Churchill's description of Russia. How the saga is resolved could determine whether ExxonMobil makes one of the biggest oil deals of the year, whether Moscow really

wants to open the country up further foreign investment, and whether Putin and the Kremlin will end their war with Russia's most powerful oligarch.

In this drama, ExxonMobil's motivations are the clearest. The newly completed merger of Yukos and its local rival Sibneft has created the world's fourth-largest nonstate-owned oil company, with a wealth of reserves and output that is rising at a rate of 20% a year. Its exploration and production costs, \$1.47 per barrel, are among the industry's lowest. All of these are attractions in the eyes of the world's largest integrated oil company. Despite its extensive acreage, ExxonMobil has seen production levels fall off in the past year. The U.S. company would also stake a big claim on one of the world's fastest-growing oil patches, and would be keeping pace with BP Plc, which in February inked a \$9.8 billion deal with Russia's TNK. As Paul Collison, a Moscow-based oil analyst at Brunswick, UBS puts it: "Russia's risk can be mitigated—and it has the reserves that the companies need." Just how eager ExxonMobil is to boost its profile in Russia. According to Collison, who recently met with ExxonMobil executives, the American oil major is willing to settle for a minority stake in any Russian venture—even though it usually demands control.

But whether ExxonMobil gets a deal depends on the Russians. Khodorkovsky stands to profit handsomely from a sale. When the former banker acquired his 36% stake in Yukos at a bargain price during Russia's privatization program in the mid-'90s, most people assumed he would cash out as soon as a rich opportunity presented itself. The surprise

A Tale of Two Oil Giants

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Production**	Production**
4.4	2.9
MILLION BARRELS OF OIL EQUIVALENT PER DAY	MILLION BARRELS OF OIL EQUIVALENT PER DAY
Market Capitalization	Market Capitalization
\$251	\$50
BILLION	BILLION

*SEC definition; yukos-sibneft puts figure at 19.4 billion. **2004 estimate

Data: Deutsche Bank, Bloomberg, Enbridge News, Reuters

IGARCH Yukos' Khodorkovsky is bankrolling Kremlin opposition hopefuls

at he actually had a head for the oil business. He seemed to relish the job of turning Yukos into a world-class oil company. And he has succeeded: Yukos is on track to log a \$4.3 billion profit on sales of \$5 billion this year. A runup in oil prices, and steady improvements in Russia's investment climate, have boosted Yukos' share price by 68% since December, to almost \$16. This could be the moment to sell. "If someone comes along and offers you a lot of money for half your company, and if you can make more money working together, then why wouldn't you?" asks Stephen O'Sullivan, co-head of research at Moscow investment bank Unitas Financial Group. Khodorkovsky would not comment for this story. But money can hardly be Khodorkovsky's only motivation. Like the U.S. oil tycoons of yore, he is also a philanthropist, sprinkling his wealth across a variety of causes, from Internet training centers to galleries. He has been bankrolling opposition candidates campaigning for par-

liamentary elections in December. But the tycoon has stirred controversy. There are currently seven different investigations pending against Yukos and its subsidiaries, with possible charges ranging from tax evasion to complicity in murder, while one of the company's major shareholders has been languishing in a Moscow jail since July on charges of embezzlement. Yukos denies all the charges, saying they are politically motivated.

PUTIN—THE WILD CARD

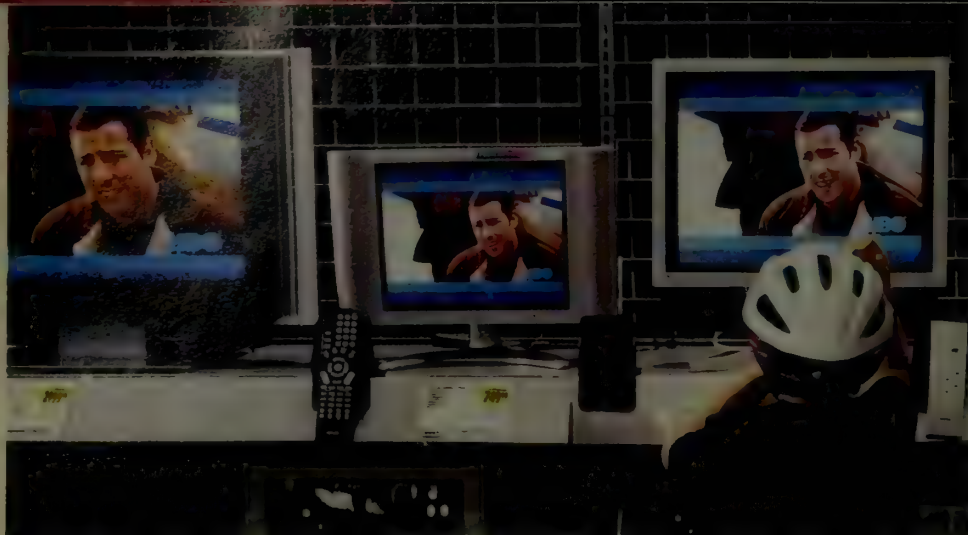
THE RELENTLESS BULLYING may have given Khodorkovsky a further incentive to find a foreign partner. Yukos' boss could be gambling that the government will cease its attacks for fear it might scare off a high-profile investor like ExxonMobil. Yet the reverse could happen: Kremlin hard-liners may go all out to prevent a big chunk of a major Russian company from passing into the hands of a foreign multinational just months before elections.

Of all the wild cards at play here, the

wildest is Putin. No major U.S. investor would dream of entering Russia without the Kremlin's consent. Putin has been a long-standing advocate of foreign investment, and only last month met with senior U.S. officials, including Commerce Secretary Donald L. Evans, to discuss cooperation in the energy sector.

So why is Putin saying one thing while Russia's police seem determined to send exactly the opposite signal? The answer may lie in the netherworld of Kremlin politics. With a presidential election approaching next March, rival factions are battling for influence, with Khodorkovsky seemingly caught in the crossfire. Putin may be calculating that the campaign against Yukos is enough to satisfy Khodorkovsky's enemies in the Kremlin without seriously affecting Yukos' development or deterring foreign investors. He'd better be careful: Even tough investors like ExxonMobil can get spooked if the game gets too murky. ■

—By Jason Bush in Moscow



HIGH TECH

LIQUID CRYSTAL PROFITS

Asian companies are scrambling to cash in on the voracious demand for LCD TVs

EXECUTIVES AT TAIWAN TV maker Teco Group are not used to getting much attention. After all, the company has been stuck for years in a low-margin business without much glamour. But that was before the advent of the new Big Thing: flat-panel televisions made with sleek, liquid-crystal diode (LCD) displays. Now, Teco, which started making LCD TVs last year, is at the center of one of the world's hottest electronics businesses. And Frank Wu, head of the group's home electronics division, boasts that his company is positioned to profit. Last year Teco sold 3,000 LCD TVs; this year it expects to sell 40,000. "We have the technology," says Wu. "We can move faster."

In fact, many Asian companies are scurrying to profit from the boom in LCD TVs. Some, such as Sharp, Matsushita, and Samsung, make money two ways: They both make the LCD panels and assemble LCD TVs themselves. Others, like Teco, purchase the panels from suppliers such as Samsung, LG.Philips—a joint venture of the Dutch electronics firm and Korea's LG Electronics—and AU Optronics, and then make TVs under their own and other companies' names. Meanwhile, computer

makers eager to diversify, including Gateway Inc. and Dell Inc. in the U.S., are selling LCD TVs under their names too.

As production rises, prices are dropping. That further increases demand from TV shoppers willing to pay \$1,500 or so for the lightweight, space-saving sets. According to researcher iSuppli Corp., the world market for the sets will rise from \$3.5 billion this year to \$9.2 billion by 2005. The price drop is making LCD TVs affordable for the middle-class. Teco's Wu says he has heard rumors that an LCD TV price war might break out during the Christmas selling season among big U.S. retailers such as Best Buy and Circuit City.

OUTSOURCING BOOM

LIQUID CRYSTAL display technology first hit consumer markets in the 1960s. By the late '90s, LCD screens were widely used in notebook PCs, cell phones, and PDAs, most of which are made in Asia. That has

NEW YORK SCREENS

As prices drop, the TVs are no longer for the rich only

given companies Korea and Taiwan leg up on the competition. Taiwan's Quanta Comput

the world's biggest maker of notebook PCs is now in the business of making LCD TVs as are smaller computer companies including Sampo and BenQ. While the companies won't disclose their clients, analysts say Sampo is making TVs for Gateway and Quanta for Sharp.

All those LCD TV manufacturers are driving up demand for LCD panels. "Companies just can't supply enough panels to the market," says K.Y. Lee, chairman of Taiwan's largest producer, AU Optronics, which has 11% of the market. The Koreans are still the big power. LG.Philips makes 21.5% of LCD panels while Samsung Electronics produces 21.2%, according to Austin-based market watcher DisplaySearch.

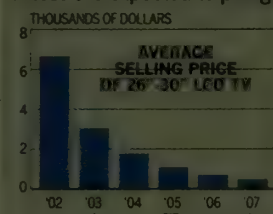
Making LCD panels—a sandwich of glass, liquid crystal, and thin film transistors—is expensive, with the tab for one factory topping \$1 billion. Moreover, TV watchers demand a higher-quality picture than computer users. So there is hot competition to increase the supply and quality of panels. Industry leaders Samsung and LG.Philips last year opened so-called Generation 5 LCD fabrication plants, which produce sheets of glass large enough to make three 30-inch LCD TVs. Each Gen5 plant costs about \$1.5 billion. Taiwan's players are responding by building their own Gen5 fabs. Not to be outdone, Samsung is skipping Gen6 and planning a \$3 billion Gen7 fab, which will produce panels that can make screens for a dozen 30-inch TVs.

Despite falling prices, profit margins in the business remain high. But diving headfirst into this new market is not without risk. As stores are flooded with the new sets, television manufacturers may find themselves struggling to make money in a crowded field. In addition, there's the threat that Chinese companies will enter the business and swamp all of them. But for now, the picture is clear—it's money-making time for a hot product. ■

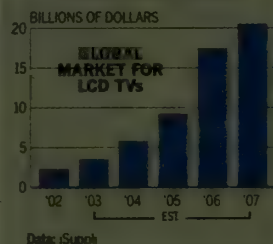
—By Bruce Einhorn
Taipei and Moon Ihlwan
Seoul, with Irene M. Ku
in Tokyo

LCD SPREE

Prices are expected to plunge...



...and sales to soar



COMMENTARY

BY BRIAN BREMNER

Currency Quid Pro Quo

Japan's Iraq aid may avert a showdown on the yen

THE BIG SHOWDOWN. That's what currency traders would normally expect to see when Japanese Prime Minister Junichiro Koizumi and President George W. Bush get together on Oct. 17 in Tokyo. After all, Treasury Secretary John Snow effectively confronted Japan on

Sept. 20 when he orchestrated a Group of Seven call for "flexible exchange rates"—a colloquial demand that both Tokyo and Beijing let their currencies appreciate. China's yuan, which trades at a pegged rate, hasn't budged. But since Sept. 1, the free-floating yen has soared. In response, after a brief hiatus, Japan again intervened in the currency markets buying dollars. Koizumi, after all, needs robust exports to keep Japan's fragile recovery afloat. And the U.S.

wants a weaker dollar to boost American exports and keep jobs.

So is the stage set for serious agreement? Don't bet on it. In the Bush Presidency, geopolitics trumps economic politics. And Koizumi is playing his geopolitical cards very carefully. At considerable risk at home, Koizumi is expected to pledge more than \$5 billion for Iraq reconstruction. Japan is also considering deploying 10,000 peacekeeping troops. Good news for Bush, who has been savaged for his

failure to line up more international help in Iraq.

Of course, even as Americans balk at the price of rebuilding Iraq, there's equal consternation about the 2.7 million U.S. jobs vaporized on Bush's watch, many of them factory slots that moved to Asia. But Koizumi now has the political cover he needs to ignore U.S. manufacturers yelping about the yen. Thanks to Japan's help on Iraq, figures Barclays Capital

Chief Economist Mamoru Yamazaki, "it will be a lot easier to intervene in the currency markets."

So don't be surprised if the Japanese prove undeterred in their determination to weaken the yen or at least slow its rise. As of Sept. 30, Japan had spent \$120 billion buying dollars in 2003. On Oct. 5, Japanese Finance Minister Sadakazu Tanigaki vowed "decisive action"

if the currency rose much beyond its recent level of about 110 yen to the dollar—already 7% above the rate Tokyo managed to maintain through most of this year. Other Finance Ministry officials are discussing raising the cap on government borrowing to fund currency interventions. That would allow for an additional \$90 billion in dollar purchases through Mar. 31.

Bush is sure to talk tough on the currency front, but in the end he'll almost certainly accept Koizumi's position. So look for Koizumi to put up serious yen and troops to help his buddy out of his Middle East jam. In return, he will want some studied inaction by Washington as Japan's financial authorities pull out the artillery again. ■



ALL SMILES

Bush is likely to accept Koizumi's currency position

Middleware. It's in the bank.

EDITED BY ROSE BRADY

Lula's Trade Crusade Is Far from Over

IT'S A RUDE AWAKENING for the Bush Administration. Brazilian President Luiz Inácio Lula da Silva, emboldened after bringing together 22 developing countries to confront the U.S. and Europe at global trade talks in September, now looks ready to derail talks for a Free Trade Area of the Americas. If Brazilian

concerns such as America's generous agricultural protections are not on the table, the negotiations involving 34 countries in Miami on Nov. 20-21 could well break down. That would deal a new blow to U.S. trade strategy.

Surprisingly Assertive

U.S. TRADE REPRESENTATIVE Robert B. Zoellick had hoped to complete both a new round of trade liberalization at the World Trade Organization and the establishment of the FTAA before January, 2005. As talks have bogged down, Zoellick has been pursuing what he calls "competitive liberalization"—an effort to forge bilateral trade pacts with countries to pressure them to agree to the broader frameworks. But increasingly Lula is challenging Zoellick at his own game. Mercosur—the customs union linking Brazil, Argentina, Paraguay, and Uruguay, with Chile and Bolivia as associates—recently signed a free-trade agreement with Peru. Talks are intensifying with Colombia, Ecuador, and Venezuela. "Our objective is to integrate South America more and more," says Brazil's Foreign Minister Celso Amorim.

The aim is not only to improve regional trade ties but also to strengthen Mercosur's hand at the Miami talks. Lula wants the U.S. to open its market to Brazilian exports of steel, orange juice, and other commodities. Up to now, however, the Bush Administration has argued for negotiating those issues as part of broader WTO talks. Meanwhile, Brazil doesn't want to discuss topics dear to Washington, such

as intellectual property rights. At a recent preparatory meeting, "what was disappointing was Brazil's unwillingness to engage," says Ross Wilson, chief U.S. negotiator on the FTAA.

Lula's tough stance vis-à-vis the U.S. is at the core of his surprisingly assertive foreign policy since taking over the presidency last January. A former metalworker and trade unionist, he has been courting allies as far away as India and South Africa. Both governments backed Brazil's challenge to the U.S. and European Union at the September global trade talks. Now, Brazil wants to create a free-trade alliance with these two other

large, developing democracies. They produce pharmaceuticals, and could try to maintain a united negotiating stand to protect their fledgling industry in global talks. "We will be able to increase trade between developing countries without having to wait for results at the WTO," Foreign Minister Amorim explains. Lula has planned trips to

Africa, the Middle East, and India to push his agenda.

What's the left-leaning President's ultimate goal? His aides insist that he does not want to destroy the

multilateral trade regime or the decade-long effort to create a hemisphere-wide free-trade zone. But Lula clearly doesn't want Washington to call the shots anymore. His assertiveness is playing well in Brazil, where his support remains strong despite 13% unemployment. As negotiators head to Miami, the Bush team can likely count on another fight. ■

—By Jonathan Wheatley in Brasília, with Paul Magnusson in Washington



HARD-NOSED
Lula wants U.S. farm subsidies on the table

GLOBAL WRAPUP

CHOPPING UP PORK PROJECTS IN JAPAN

FRESH FROM his reelection as ruling Liberal Democratic Party chief, Prime Minister Junichiro Koizumi is flexing his political muscle. Target No. 1 is Haruhiko Fujii, the reform-resisting president of Japan Highway Public Corp. Koizumi wants to privatize the money-gushing state-owned highway corporation. On Oct. 6, his Transportation Minister, Nobuteru Ishihara, fired Fujii. It was a shrewd move by Koizumi. Japanese commuters endure some of the highest highway tolls in the world, so few will shed tears for Fujii, a career bureaucrat. And severing state ties with the entity will bring to an end wasteful pork-barrel projects that have left government finances in a mess. The gambit also enhances Koizumi's reformist credentials going into an expected general election set for November.

A BREAKTHROUGH IN U.S.-TURKISH TIES

TURKEY IS likely to send up to 10,000 troops to Iraq by yearend, despite initial Iraqi opposition to the Turkish Parliament's Oct. 7 decision to deploy peacekeepers to assist struggling U.S. military forces. Some members of the U.S.-appointed Iraqi Governing Council voiced reservations about the Turkish deployment, but the ultimate decision is Washington's, officials say.

The 358-183 parliamentary vote is seen as a victory for Prime Minister Recep Tayyip Erdogan. He wanted to repair Ankara's relations with Washington, damaged when the Parliament refused U.S. troops passage through Turkish territory on the eve of the war. Now, Turkey will receive \$8.5 billion in U.S. loan guarantees

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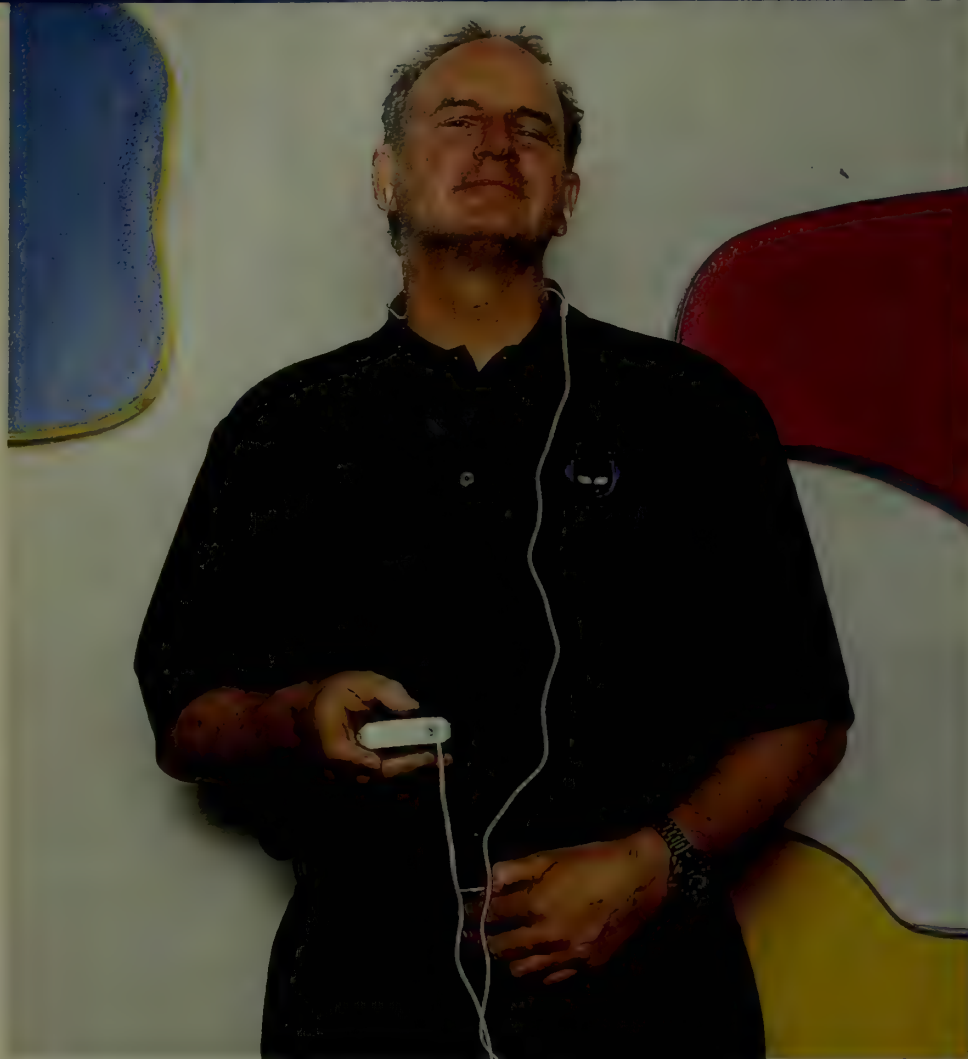
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Napster Lives Again —Sort Of

Its new owner has made nice with the music industry. But will fans return?

WHEN NAPSTER INC. announced its liquidation on Sept. 4, 2002, it seemed like the end of the road for one of the Internet's most famous brands. Bled by lawsuits and unable to cobble together an agreement with the recording industry to make the service legit, the company finally called it quits. While others mourned or cheered Napster's passing, Christopher Gorog, a restless en-

tertainment veteran turned tech exec, smelled opportunity. Napster had kick-started the digital media revolution and attracted 60 million avid fans. "It was colossally stupid that the record companies and Napster hadn't found a way to turn one plus one into two," says Gorog, who took over as chief executive of Silicon Valley-based software maker Roxio Inc. in 2000. "Something started brewing in my head."

Now, after a long, unlikely crusade, Gorog has brought Napster back from the dead. He is scheduled to take the stage at a

TUNED IN Roxio CEO Gorog with the Samsung Napster player

New York hotel on Oct. 9 to introduce Napster 2.0. The new service is Napster in name only, at least so far. Rather than a free

way to share music files, it's a legal way to buy direct from record labels. After buying Napster out of bankruptcy in November 2002, for \$6.1 million, Gorog shelved its file-sharing technology. Instead, the new Napster offers 99¢-per-song downloads and a \$9.95 monthly subscription service that gives customers extra features such as streaming songs to their PCs. Gorog is confident that the service can be as revolutionary as its namesake, helping drive the digitization of music and benefiting record companies, artists, and consumers. "We're going to make the record companies a lot of money," he says. In the future, though, the company could use Napster's patent to offer a legal form of file sharing.

Gorog's strategy could backfire quickly if music lovers decide it's a cynical attempt by corporate suits to wring profits from their icon. "Napster was an underground thing. You felt like you were part of a subculture," says Steven Sarro, a 17-year-old from Alameda, Calif., who started his music collection using Napster. "If you have to pay to use it, it's not going to do well." Even Roxio's partners are taking a wait-and-see attitude. Asked days before the launch if Gorog was smart to revive the Napster name, Dave Fester, general manager of the Microsoft Corp. division that licenses music and video software to Napster, took a long pause before replying, "I don't know."

The revival of Napster tells much about the challenge of building a compelling, legal music service. An industry insider Gorog knew the labels would never license music to Roxio-owned Napster unless he dropped the file-sharing technology that incited their ire. Instead, Gorog focused on creating a site where users could discover new music—an online version of a group of college friends, sharing music tips. That way, he hopes to attract old Napster fans and anyone bored by the radio and the CD collection. Beyond downloads, subscribers will get an online magazine, exclusive live recordings of up-and-coming acts, and more extras for their \$9.95 monthly fee. To woo fans for whom Napster means free, he launched an edgy marketing blitz in June, including online cartoons featuring Napster's famous cat mascot. "The brand has to seep back up from below," Gorog says.

Gorog has succeeded in establishing solid footing for the revised Napster

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Resurrecting Napster

Roxio wants to parlay the Napster name into a site that stands out from a slew of legal online music services. Here's the plan—and the challenges:

THE PLAN...

BRAND THE KITTY Roxio is trying to cultivate a hip image with edgy online cartoons and TV ads featuring a silent, inscrutable cat based on Napster's logo.

CREATE A COOL COMMUNITY Napster 2.0 subscribers can check out new music by looking at other users' playlists, by reading an online 'zine, and by hearing exclusive live recordings from bands like Eve 6 (left).

OFFER UNMATCHED VARIETY Napster 2.0 will offer 500,000 songs, more than any other online distributor, thanks to Roxio's purchase of music service pressplay.

EXPLOIT ECONOMIES OF SCALE The pressplay purchase gave Roxio 400,000 customers, twice that of Apple's iTunes, one consultant estimates.

THE CHALLENGE

No matter how cool the kitty, the for-fee service won't be anything like the rebellious and free file-sharing Napster of old.

Rivals Rhapsody and Musicmatch offer many of the same goodies. And with just 20 people creating content for Napster, it will be hard to stand out.

If Roxio doesn't keep breaking ground, heavyweights such as Amazon.com and Wal-Mart will catch up.

Apple's iTunes Music Store will launch a Windows version this month that could quickly eliminate Roxio's lead.



many fronts. In May, Roxio doled out \$39 million for pressplay, a three-year old music subscription service formed by Universal and Sony Music Entertainment Inc. Pressplay gave Roxio access to a trove of music licenses, the technology required to sell songs via the Net, and a head start on subscribers. Now, Napster consumers will be able to choose from more than 500,000 songs—almost double rival offerings. Consultancy Adventis Corp. says pressplay had 400,000 subscribers as of this summer, twice as many as Apple Computer Inc.'s iTunes Music Store, though rivals dispute pressplay's figure. Gorog also persuaded Samsung Electronics Co. to create a portable music player tuned for Napster 2.0—an effort to match the easy-to-use combination of Apple's iTunes and iPod players. "When Napster becomes available, people will at least check it out," says U.S. Bancorp Piper Jaffray Inc. analyst Eugene C. Munster. Investors have already taken note, propelling Roxio's stock up 217% to \$10.72 since it bought Napster.

A HOST OF RIVALS

THE CHALLENGE WILL be getting the site to stand out in a crowd. Offering downloadable songs for 99¢ apiece and a monthly subscription of unlimited streaming music for about \$10 is exactly what Musicmatch Inc. and RealNetworks Inc.'s Rhapsody do. And a whole host of new online music services are on the way. Apple is expected to announce a Windows version of its service later this month. By early next year, services should be available from Amazon.com, Sony, and Wal-Mart.

That's why making Napster fly again will face long odds. Gorog is probably right in betting that people will visit the

site, especially given the pressure from the record industry's lawsuits on illegal file-sharing. But visitors may well be disappointed. Unless its six-person team can turn the magazine into a must-read or its exclusive recordings can stand out from similar fare on rivals' sites, Napster could quickly fade away. "Eighty percent of Wall Street is skeptical right now," says Piper Jaffray's Munster. More bullish than most, he estimates that Roxio will sell 1 million songs a week by Christmas. Though that's neck and neck with his estimates for Apple, it's 300,000 short of the tally he figures Roxio needs to break even.

A slow start could lead to ugly results. While Gorog focused on Napster, Roxio's core business of CD burning software has suffered. Munster expects the company to lose money for the first time since going public. Projections: Sales could shrink 17% to \$100 million in the fiscal year that ends Mar. 31, 2004.

Gorog, who plays bass guitar with other L.A.-area executives, has been itching to make a place for himself in online music since 1999. Tired of running business development for Universal's theme park division, he agreed to oversee the sale of Universal's concert promotion business. By the time the unit was sold to HOB Entertainment Inc., the owner of House of Blues, Gorog was its chairman and interested in posting performances online. The tech wreck forced House of Blues to cancel those plans, but soon after Gorog got a call from a headhunter that revived his dream. Storage software maker

Adaptec Inc. wanted to spin out a unit later named Roxio, which made a burning software package that is preloaded on many home PCs.

Gorog felt he could use the software offer more services and began pitching vision to Roxio's board and his music industry connections. The dream quickly turned into reality when Napster went into liquidation. The day before the Napster purchase was announced, Gorog called former Universal colleague Michael Bebel, who ran pressplay. Gorog and Bebel quickly persuaded Universal and Sony executives that combining pressplay into a legal Napster would be the best way to spur online sales.

Roxio's marketing strategy has been carefully crafted. Focus groups showed the Napster brand had great strength. Nearly 98% of Net users knew the name and 47% said they would pay for music sold by Napster. To maintain Napster's rebellious feel, the company began posting the edgy cartoons. In one, the inscrutable cat, exuding Zen-like confidence, lands a licensing deal with haggling music executives. The company says 1 million people had watched the animations.

While Napster's launch will generate buzz, this may be its one and only chance to establish itself in the emerging online music business. It's a long shot. But Napster 2.0 can recapture any of the magic of its namesake, the kitty will get a lease on life. ■

—By Peter Burrows in Santa Clara, Calif.

Roxio has faltered as Gorog focused on Napster

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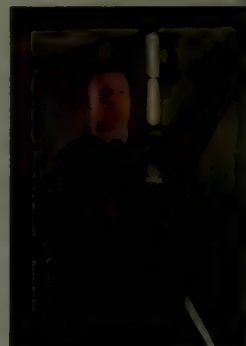


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This is not a drill. A recent study identified financial statistics, R&D data, strategic plans and customer lists as the top information items stolen from companies. Why? Because the more this information empowers you, the more valuable it becomes. Unprotected, it makes a juicy target. But even random attacks can cost you. The Radicati Group says malicious code will cause over \$57B in economic damage by 2006. The answer? Security solutions that work inside, outside and end to end.



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POWER SURGE

Under CEO
Baum, Sempra's
profits jumped
50% since 1999

Sempra's Golden State

The California energy player figured out how to prosper while its rivals floundered

THE DAMAGE FROM CALIFORNIA'S three-year-old energy crisis lives on. Rocked by tumultuous swings in power prices, giant utility PG&E Corp. saw its two major business units collapse into bankruptcy. Neighboring Edison International rang up billions of dollars in debt. The crisis even helped fuel the campaign to recall Governor Gray Davis.

In San Diego, complaints were so loud among Sempra Energy's 22 million customers that Chairman and CEO Stephen L. Baum watched as consumers burned their bills in front of the company's

headquarters. "It was the French Revolution syndrome," Baum recalls. "They were looking for somebody's head."

Baum didn't just escape the guillotine—he figured out how to profit from the energy fiasco. While the utility sector has floundered, Sempra's profits have jumped by 50% since 1999. The company expects to earn \$600 million on sales of \$6.6 billion this year. The stock, recently at \$30 per share, returned 99% to shareholders from Dec. 31, 1999, through Sept. 30, 2003, vs. an 11% drop for the Standard & Poor's Utility Index.

Now, Baum, an affable 62-year-old former Marine Corps captain, is using that financial strength for an ambitious ex-

pansion. Since 2001, Sempra has spent \$1.5 billion to build three power plants. Baum is also looking to invest \$1.3 billion over the next five years to stake out a leading position in the emerging market for liquefied natural gas (LNG), the nonpolluting fuel of choice for utilities.

SHREWD DECISIONS

Critics—and there are plenty—say Sempra inflated the cost of energy while at the same time signing a lucrative contract to sell power to the state at high prices. It still faces state and federal investigations. But it now seems possible that Sempra will sail through the crisis largely unscathed. "It's tough not to conclude the worst is well behind them," says Michael R. Peevey, president of the California Public Utility Commission.

The roots of Sempra's success lie in a decision Baum made in 1998 as he was considering how Sempra could prosper under California's new energy-deregulation law. He chose to sell the company's plants, a move that allowed Sempra to get out from under a state-imposed cap on what it charged consumers.

The second shrewd move came in early 2001, when a desperate Governor Davis signed long-term contracts with 27 energy companies to supply power. Sempra snared a 10-year deal worth \$6.6 billion. Wholesale electricity prices have fallen 85% since then, and Davis pressured most of those providers to renegotiate. Sempra refused—and has so far withstood challenges from California in state court and federal regulators. Says Baum, "These weren't babes in the woods that we negotiated with."

The California contract helped Baum to finance the three gas-fired power plants he opened last summer in Arizona, California, and Mexico. Now, he has his sights set on liquefied natural gas. With gas prices high, Sempra is racing to open facilities in Mexico and Louisiana that will convert imported LNG back into gas. Big guns such as Royal Dutch/Shell and Marathon Oil Corp. are also chasing LNG, but Baum got an early start.

Sempra hasn't completely put the crisis behind it. It's one of several dozen companies negotiating settlements with federal regulators over charges that it benefited unfairly from California's energy crisis. The betting among energy experts is that Sempra may have to refund tens of millions of dollars. But considering the battering that most utilities and power plant builders have taken, Sempra could still emerge looking like a winner. ■

—By Christopher Palmeri in San Diego



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The Real-Time, Right Now Enterprise

Coke's latest message is "Try to make it Real." Reality shows are still the hottest network bet. And news channels use tickers at the bottom of our screens to pump us with more information lest we miss prior or future coverage during the broadcast. All of these are hints to the business community that say, as a culture, we want our information now.

Real-time computing continues to be the focal point for IT departments and management teams because it allows companies to make faster, more effective decisions. Don't be surprised if Boardrooms start looking like control centers with dashboards of key business indicators flashing. Company Web sites too, will soon be augmented with graphical gauges of business performance and shareholder information. Not only will employees have customer information at their fingertips, but they'll also have predictive data on what a specific customer would most likely buy, or even whether there are any indications that a customer may be lost – all *before* they ever talk with the customer directly. Real-Time Enterprises (RTEs) are happening right now – *in all industries and all size companies*. Companies such as GE and IBM are already claiming that real-time computing is saving them \$1.5 billion or more per annum. In any economy, those are numbers that just can't be ignored.

Real-time is a relatively simple concept by which critical business information is available and can be acted upon at any time. Gartner Inc., a technology research and advisory firm, defines real-time as the complete compression of lag – between

the detection of an event, the reporting of that event, the decision-making, and the response. They further note, "The RTE is an enterprise that competes by using up-to-date information to progressively remove delays to the management and execution of its critical business processes." Examples range from immediately replenishing inventories due to unexpected swings in demand, to altering prices throughout a retail chain in response to competition, to monitoring stock trading close enough to see potential issues before they result in SEC involvement. Call it 'real-time,' 'near real time,' 'right-time,' or 'on-time' computing – whatever your favorite term, IT's overall goal continues to be to help management have all the necessary information at their fingertips to be accurately proactive – or at least reactive, as quickly as possible.

Aberdeen Group, Inc., a computer and communications research and consulting organization writes that the "RTE delivers three real-world benefits that impact the bottom line: 1) proactive management of opportunities; 2) tactical responsiveness; and 3) strategic flexibility." Aberdeen's Alex Veytsel suggests that organizations looking to make themselves more real-time have

TEA & PeopleSoft's Services Procurement System

By using PeopleSoft's Services Procurement system, the Texas Education Agency (TEA) has a goal of saving over \$1 million per year by improving the way they manage service contracts and service suppliers. The online system was put into place to provide easier access to information for administrators, service suppliers and TEA managers. The system helps TEA in a number of ways including:

- Providing a self-service Web page for each of their suppliers to help speed up the invoice-to-payment process. Suppliers get paid faster and thus are happier.
- Allowing TEA to analyze its current relationships with its suppliers in terms of cost, quantity and efficiency. Previously this was only done annually but now can be done instantly, providing a way to adjust purchasing and program content decisions as necessary.

one of two motivations: either reducing risk, or taking advantage of opportunities. Risk reduction may come in the form of fraud detection, credit risk assessment or compliance risk. A formidable example of this is the new requirement from the Sarbanes-Oxley Act that requires public companies to report immediately on materially significant changes in the business. Opportunities, as Veytsel describes, can be better cross-sell analysis of a profitable customer or the overall improvement of customer service to encourage loyalty and expansion of overall walletshare.

Keith Raffel, chairman and founder of Upshot Corporation, a Web-based sales management provider, noted that he uses the Upshot system to manage his sales forecasts in real-time. "The old way of doing forecasting was to wait until the quarter closed or was nearly closed and have each rep submit their next quarter forecasts to a central system or department, which would roll them all up into a management level report. This could take several days to several weeks to complete. Many, if not most companies still operate this way," Raffel continued, "Now using technologies like Upshot, managers can effectively have critical pipeline information available and up-to-date all the time. We call this 'info to go.'"

However, real-time computing isn't something that just happens. It must be carefully planned and executed

as part of the overall enterprise's business strategy. Real-time computing isn't just about technology as it affects the entire infrastructure and culture of the organization. In considering a real-time strategy, there are some significant issues to consider:

1. DATA AVAILABILITY – What information is available in the organization and what decisions would improve with



quicker delivery of the data? Once it is clear what needs to be made faster, IT can focus on ways to do this within the constraints of the technical infrastructure and available budget.

2. DATA ACCURACY – What measurements are in place to ensure that data is accurately being captured and processed? If there are no standards or procedures ensuring that the data

being inputted is accurate, you may have a lot of available data that is not usable.

3. MANAGEMENT – Has your company's management team been trained to respond to instantaneous data feeds, and are they prepared to respond to issues as they arise on the spot? Managers may need new training to help them understand critical business indicators, and plan potential solutions to problems before they happen.

4. EMPLOYEES – Can your employees respond to rapid change? For example, retail management may determine that specific products should be pushed in response to a trend or seasonal opportunity. That decision is only as good as the rate at which this can be enacted in the branches through the individual employees. Additionally, what roles do employees play in the gathering and analysis of business information? Are sales people accurately reporting win/loss reports so that management really knows what is working and what is not?

5. SUPPLIERS – Without the support and integration of your various suppliers you may never be able to achieve a true real-time environment simply due to the fact that your supply is critical to your ability to deliver to your customers.

6. CUSTOMERS – Understanding what is important to your customers in terms of real-time is paramount. A customer may prefer to have certain things, such as service information or product delivery information available to them in real-time. However, they may be reasonably satisfied with less than real-time access to historical purchase information. It is equally important that customers can exchange information with the company as well. Building a bi-directional flow of information is critical in building an RTE.

7. COST – Most importantly, as organizations find areas to improve



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their business responsiveness, the cost of improving the systems and people adds up. Therefore, organizations will have to intelligently select which areas of the business need real-time information, in order to bring them strategic, competitive value.

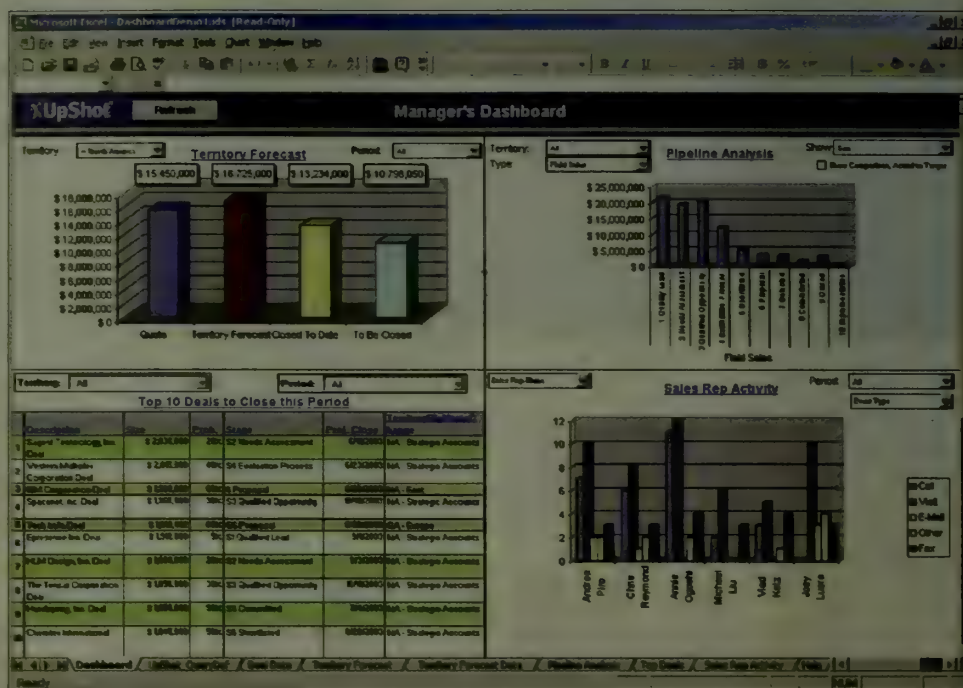
Many technologies come to bear in delivering real-time information and the tools to use that information. Some of the new ones to look out for include:

■ **Events or Alerts** provide a way to notify specific individuals to changes in acceptable thresholds or other standard procedures. An alert may be set to notify a manager when an inventory level is low or if customer retention may be at risk because of diminished activity, or even to notify a salesperson that a customer's balance remains unpaid or is delinquent.

■ **Management dashboards** provide a consolidated, user-friendly way to look at key performance indicators (KPIs) and observe the various levels of activity within the business. Such dashboards are, in fact, graphical applications representing dials, gauges, dynamic charts and graphs that allow managers to have a better sense of actual business performance than the typical management reports, which may take more time to develop, deliver and decipher.

■ **Wireless, mobile devices** including handheld computers, cell (smart) phones with and without video and Internet connectivity, laptops, personal data assistants (PDAs) and others enable users to be untethered. This means that customers can interact with a company anywhere, anytime, not just at a store or from their home. It means management can be on-location getting necessary information downloaded on-demand. It also means customer service can be more effective having the necessary information and tools at the place of service. Other technologies, such as radio-frequency

Managing Sales Forecasts in Real-Time with the Upshot Dashboard



identification tags (RFID) and GPS devices are also becoming very cost effective, enabling the practical collection of information in many ways previously inaccessible.

■ **Real-time databases** leveraging the past 30 years of database design advances have paved the way for the new database systems coming to market that optimize the transactional capabilities of relational systems, while maintaining the adaptability of object-oriented systems. Some new vendors are moving aggressively to capture relevant data as a stream rather than within a static data structure, to provide a more dynamic view of information as it flows in and out of the business.

■ **Analytics applications** are getting easier to use and are more focused than the traditional statistic analysis tools offered. The new, pre-packaged systems are intended for general marketing personnel, as well as for use by those on the front lines. Once the domain of the large catalogue retailers, analytics are now in the mainstream, helping businesses large and small improve customer service by predicting customer

needs. These systems have the ability to answer questions concerning customer retention, cross-sell (aka next best product) recommendations and pricing elasticity analysis.

■ **Real-time integration brokers** utilize a common notion of messaging and message-oriented middleware (MOM) to help integrate disparate systems to deliver a consolidated set of data and unified transaction response. Changes in data state (for example an address change or purchase made) will be propagated to all systems needing that information.

■ **Portals, instant messaging, webcasting and knowledge management tools** are already being used to help train and assist employees and customers to collaborate with and between one another. As has been shown in numerous reports, customers who can help themselves are more satisfied than those that have to rely on talking with a customer service representative. Additionally, customer service representatives who are able to better service customers are also more satisfied in being able to do their jobs more effectively.

Seamless Integration, A Key To CRM Success

See "Integration Key To CRM Success," eWEEK, May 12, 2003

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\$900M Waters Corporation has already received a \$2 million or 35 percent internal rate of return this year from their RTE initiative. Waters Corporation develops products and solutions that improve laboratory effectiveness for pharmaceutical, life science, environmental, food and beverage, agriculture and industrial applications. By implementing mySAP CRM, Waters increased the percentage of chemistry sales generated from less than one percent to four percent (\$4.6 million) and with that, they doubled the average dollar amount per transaction. The new system also helped them to improve the efficiency of their lead qualification, to subsequently capture more than \$800,000 in new sales.

Many advocates of RTE see Customer Relationship Management (CRM), Supply Chain Management (SCM), and Enterprise Resource Planning (ERP) coming together toward overall coordination through Business Process Management (BPM). In a white paper written by Werner Vogels, Cornell University's Department of Computer Science, Vogel notes, "We have seen that the set up of real-time operations in the front-office has led to staggering problems in other parts of

the operations. This is largely because most of the business process remains implemented as a batch process." Vogel continues, "In the past five years, automating large parts of the supply chain have enabled businesses to reduce inventories significantly, making them leaner and more profitable. However, it has also left them more vulnerable to shortages and hick-ups in the supply chain, and the lack of buffering forces them to respond to changes at their suppliers in real-time."

Peter Fingar, author of several books on technology and business including "The Real-Time Enterprise" and "Business Process Management: The Third Wave" stated, "Real-time involves both the tactical activities of marshalling resources to allow collaboration, as well as the strategic goals of automating the outward facing business processes." Real-time can provide an added value to customers that may overshadow the actual product or service being delivered.

"Although many real-time technologies are new, the problems that they aim to solve are perennial. Impressive as they are, think what marvels King Tut could have built with real-time systems helping to manage the supply chain, when building the great pyramids," quips Fingar. His opinion is that while real-time and its integration into business process management may not exactly parallel the building of the pyramids, he does believe it will shape how we build lasting enterprises for the next 20-30 years.

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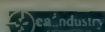
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Putting Carbon Dioxide in Its Place

“Sequestering” emissions may be the best way to fight global warming

AHOLE IN WEST Virginia may help keep the world from heating up. In late May, a group of scientists and engineers began drilling a well 9,190 feet down into a deep aquifer beneath an American Electric Power Co. coal-fired power plant. Now the hole is finished, and researchers are analyzing samples they've brought up from each layer in the earth. The aquifer, along with other geological formations, may someday provide a home for millions of tons of carbon dioxide now being spewed into the atmosphere by the burn-

ing of coal, oil, and gas. Sequester enough greenhouse emissions, and it may be possible to slow global warming.

It's a controversial plan—and not just because global warming is still questioned in some circles. If capturing and storing carbon is feasible, environmentalists fear that nations may ease up on efforts to boost energy efficiency and develop renewable resources. “We can't allow it to be a substitute for reducing emissions,” says Philip Clapp, president of the National Environmental Trust.

Yet economic models show that carbon sequestration is cheaper than most emission-cutting strategies. So even

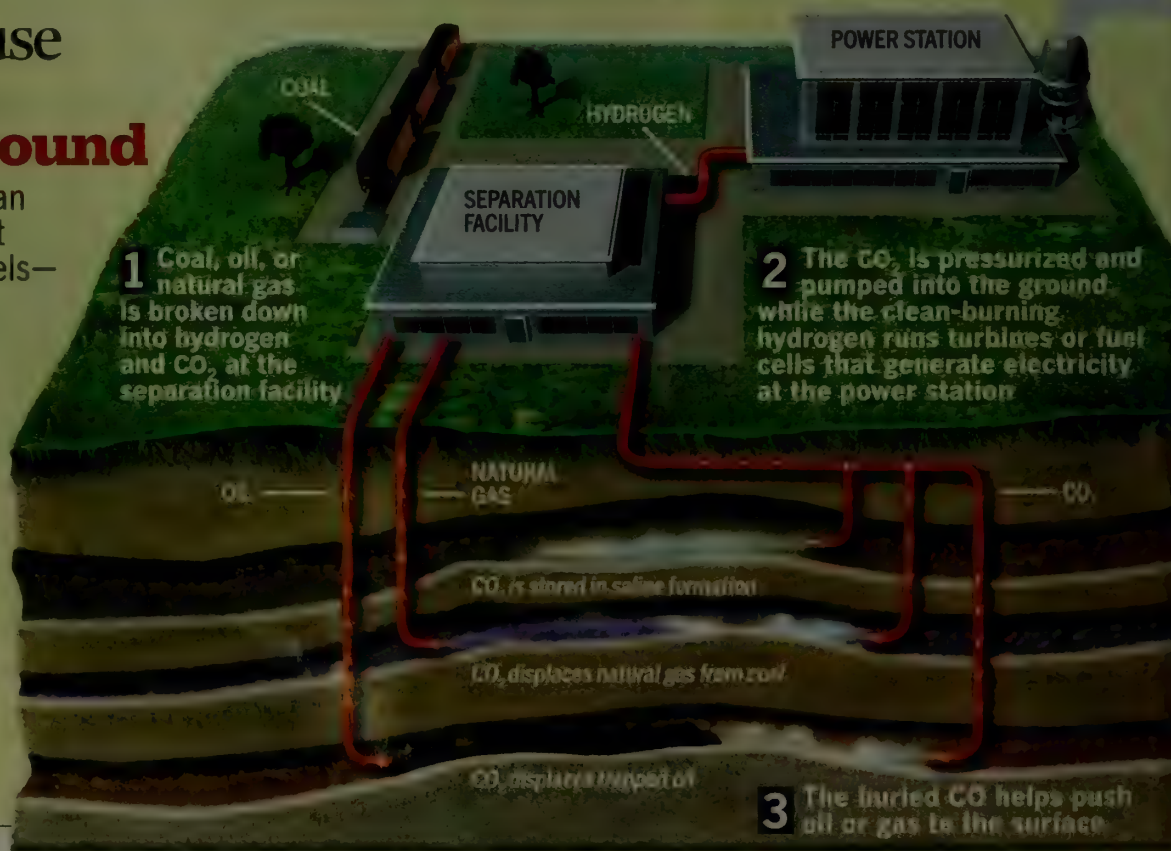
many enviros view it as a vital strategy. And power-industry execs say it's virtually inevitable. Whether or not you believe in global warming, regulations restricting the release of CO₂ are coming, says Dale E. Heydlauff, AEP senior vice president for governmental & environmental affairs. “We are going to live in a carbon-constrained world.” At the same time, there's little prospect of weaning the world from fossil fuels such as oil and coal. “Put the two together and we need to figure out how to use coal more efficiently—and we need to capture CO₂ and store it permanently,” says Heydlauff. “That is the dream.”

The dream is closer to reality than most people realize. “Every single major component is being done,” says Howard J. Herzog, professor of chemical engineering at Massachusetts Institute of Technology. “There's no doubt it is technically feasible.”

Indeed, since the 1970s, oil companies have pumped CO₂ down many oil wells to make oil more fluid and easier to bring to the surface. Now, they're also testing the idea of sealing the gas underground. Three years ago, for instance, an international group began pumping CO₂ into the Weyburn oil field in Saskatchewan. So far, the results are promising. “What this offers is a solution to the greenhouse gas problem in the oil and gas industry's backyard.”

Greenhouse Gases Go Underground

Global warming can be tackled without giving up fossil fuels—if carbon dioxide can be captured and buried for thousands of years below ground. Here's how:



says geochemist Bill Gunter of the Alberta Research Council.

Geologists calculate that depleted oil and gas fields, aquifers, and other underground formations could store trillions of tons of CO₂. That's plenty of space, given that the world's current emissions of the gas from fossil fuel use are about 22 billion metric tons a year. And economists peg the burial cost at a relatively affordable \$1 to \$8 per ton of CO₂.

More expensive is capturing the gas in the first place. The standard way is to bubble the stuff spewing out of power plant smokestacks through a liquid solvent. The solvent dissolves the CO₂, then heating the solvent releases the gas. The process is well understood but takes lots of energy. As a result the cost is high. That's why energy companies launched a research effort two-and-a-half years ago to lower the cost by half to three quarters. "We've gone a long way to identifying the technologies," says Vello Kuuskraa, chair of the project's advisory board.

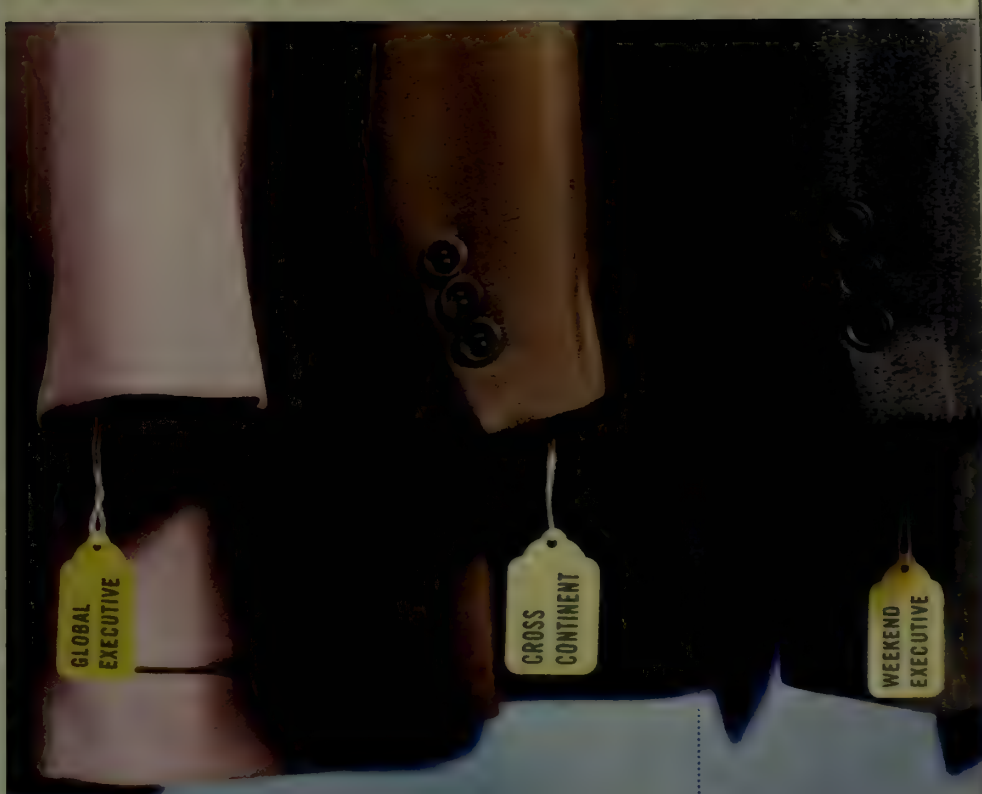
EARLY SEPARATION

ACCORDING TO MOST experts, though, the best approach would be to grab the CO₂ out of fossil fuel before it's burned. In a process called gasification, coal is converted into hydrogen and carbon monoxide. The hydrogen can then be used to make electricity or to power cars, and the CO is easily reacted with oxygen to make CO₂. U.S. utility companies and the Energy Dept. are planning a \$1 billion coal gasification project, called FutureGen, to generate power and store carbon.

Proponents are hoping the plant will demonstrate that the approach works in time to get the technology into power plants that will be built in China and elsewhere in coming decades. "It's absolutely critical that we develop methods of burning coal cleanly. That means with gasification and sequestration," says Clapp. The companies have pledged \$200 million for FutureGen, but Congress has yet to appropriate funds for the rest.

To environmentalists who would prefer to reduce emissions in the first place, the idea of capturing and storing carbon is a bit unsavory—like tackling obesity by developing yet more low-calorie foods instead of cutting excessive consumption. But inelegant as it may be, carbon sequestration appears to be the quickest and cheapest route to fighting global warming. ■

—By John Carey in Washington



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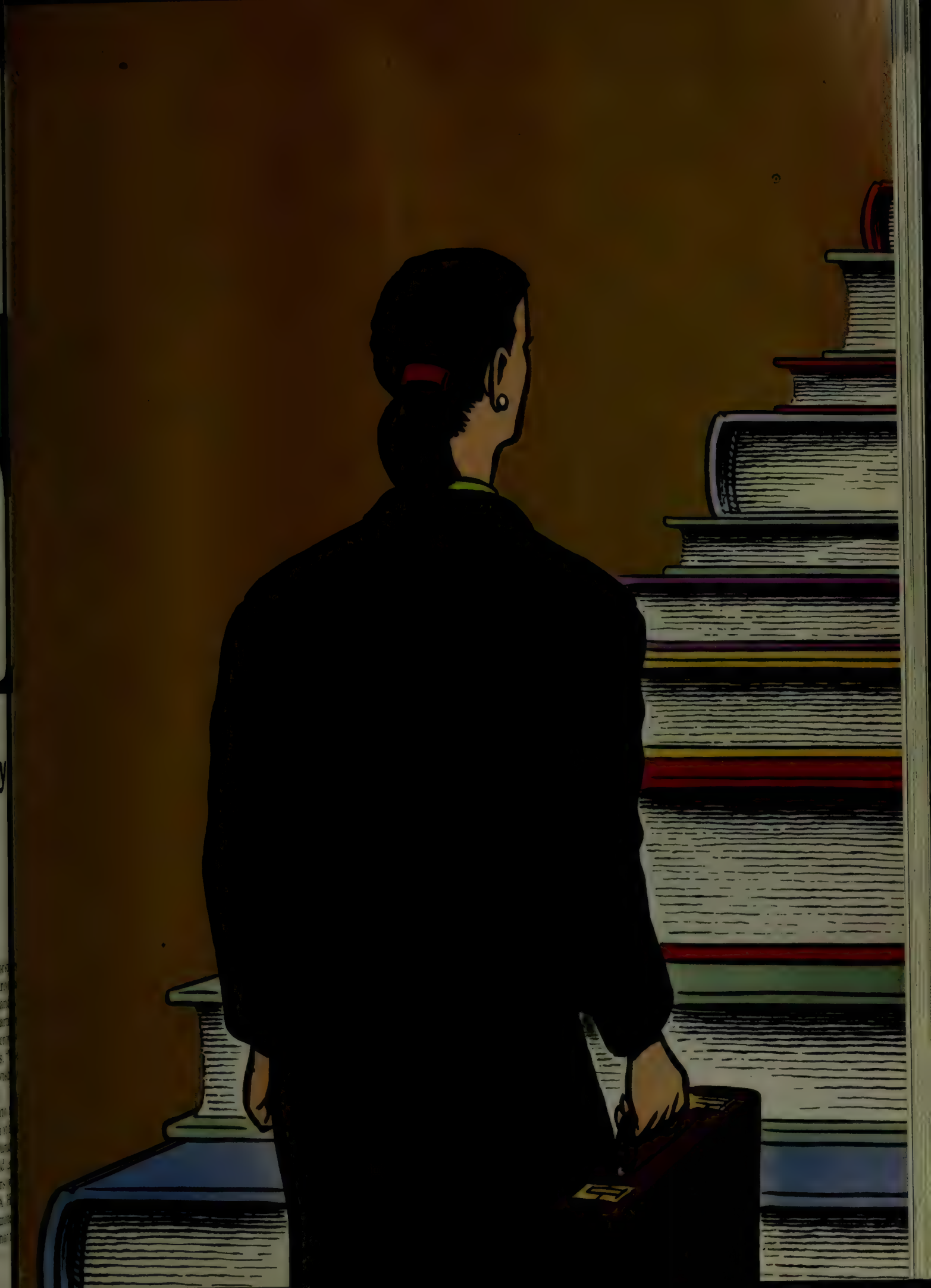
After several bleak years, companies are jumping back into exec ed programs—but they want them their way. BY JENNIFER MERRITT

BACK IN 1997, WHEN HABITAT FOR HUMANITY INTERNATIONAL'S Ted Swisher returned to his Americus (Ga.) office after a six-day executive program at Harvard Business School, he had only one regret: that his vast network of colleagues hadn't attended, too. The insights and perspective he gained would be invaluable for senior staffers who manage the housing non-profit's 2,100 worldwide chapters, but Swisher figured the program's cost—thousands of dollars per person—was way out of reach for the largely volunteer organization.

So Habitat continued to hold its training sessions in church basements and community centers, plodding through the nuts and bolts of raising money and selecting families to build homes for. Every few years, the group sent another exec to the Harvard program and again, the idea of partnering with Harvard would tantalize. But Swisher, Habitat's vice president of U.S. affiliates, wanted more for his staff. So last fall, Swisher decided to plunge

in and ask the prestigious school to cut Habitat a deal. It worked: Harvard offered the group a three-day program at cost, nearly a 20 faculty members involved agreed to teach for free, and a grant helped Habitat winnow the cost to just \$500 per participant. This June, Harvard played host to its largest exec ed crowd yet, some 400 of Habitat's senior staffers and field advisers. "We wanted to step back and look at the big picture," says Swisher. "The experience was enlightening and affirming."

It's that flexibility and impact that thrust Harvard into the No. 1 spot for executive education again this year, a perch it held since 1997. Since then, the school has increased the number of open enrollment programs it offers from 56 to 80 and continues to wow the corporate world's most senior managers with its Advanced Management Program, a sort of mini-MBA. Harvard also has remained a powerhouse in leadership, strategy and general management, according to the companies that re-



ed executive education providers for *BusinessWeek's* biennial ranking, which for the first time ranks open-enrollment and customized programs separately.

Corporate managers and human resources directors from 134 companies in 20 countries responded to *BusinessWeek's* survey of executive education this year. Their responses helped form the basis of the rankings of the open and customized programs (table, page 90). All told, the companies sent more than 21,400 employees to courses and spent some \$210 million in training dollars at B-schools and non-university-affiliated organizations such as the Greensboro (N.C.)-based Center for Creative Leadership and the American Management Assn. in New York. That comes to about one-third of total revenues reported by executive education providers, or \$662 million in 2002-2003. *BusinessWeek* again presents an exclusive ranking of the Top 25 Executive MBA programs (page 94). Both rankings were completed in collaboration with Boston-based Cambria Consulting Inc.

WANTED: RESULTS

NEXT ON THE EXEC ED LIST is the University of Pennsylvania's Wharton School, ranked No. 2 in open enrollment. The school's partnership with INSEAD (No. 5) has strengthened its position with global companies and its longstanding reputation as a finance powerhouse continues to woo managers to its Philadelphia campus.

At No. 3, the University of Michigan Business School gets credit for helping manage change and teaching companies to think through new ways of competing. And Michigan may have some of the freshest ideas about executive education, as the school revamped its offerings and has begun to link up with other campus departments and professional schools to offer jointly taught courses, like its new program in health-care management and leadership development given by faculty from the business school, School of Medicine, and School of Public Health.

For corporate respondents, getting tangible results from executive training was more critical than ever. After several bleak years, many companies have been pressed for profits and have scaled back their once-robust training budgets. That's particularly true for open enrollment programs, which can cost anywhere from a few hundred dollars for a day-long class to more than \$50,000 for a six-week intensive seminar for senior managers. Those are often offered as perks for up-and-coming managers—only to be cut when budgets are tight. Still, schools say the half-empty classrooms of the past two years may not stay that way for long. At many schools, including Harvard, University of Michigan, and Northwestern University's Kellogg School of Management, for example, open-enrollment courses for the fall



The half-empty classrooms of the past two years are filling up as companies look for help

are filling up—and some are even selling out again. “[The numbers] are beginning to build back up as companies are starting to look for help,” says Stephen Burnett, associate dean for Kellogg executive education programs. Two new programs that the school has started in the past year—Kellogg on Branding and Women Director Development—are fully subscribed in their first go-round.

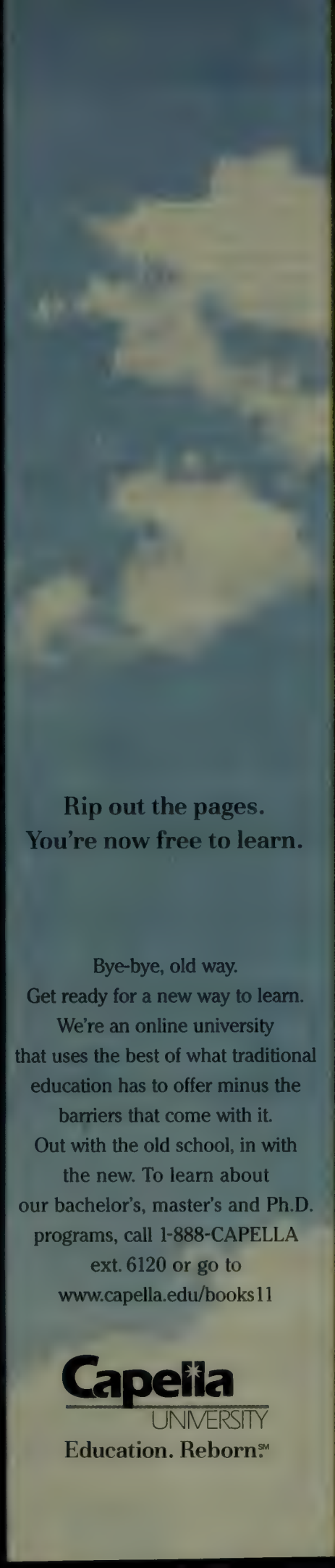
But some companies, feeling huge financial pressure, are upending decades of corporate tradition and slashing the training spending nearly completely. Ford Motor Co. for one canceled many of its executive education programs 18 months ago and decided to hold back spending until managers could decide what exact training—and how it would help their business lines. Some other companies, like Boeing Co., are bringing leadership training and other programs in-house, hardly using outside providers at all. Some employers, though, reluctant to give up everything, are demanding more from the schools. They’re asking for coursework to be custom-designed and for executive education providers to home in on internal business challenges rather than have their executives spend

The BEST of the Bunch

Companies say these schools hit the mark in meeting their training needs

LEADERSHIP	MARKETING	STRATEGY	GLOBAL BUSINESS
Center for Creative Leadership	Kellogg	Harvard	INSEAD
Harvard	Harvard	INSEAD	Harvard
Wharton	Wharton	Wharton	Thunderbird
IMD	Columbia	Kellogg	IMD
INSEAD	INSEAD	Columbia	London Business School

Data: *BusinessWeek*, Cambria Consulting Inc.



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days away from headquarters with managers from other companies.

In fact, nearly 42% of respondents said they were sending fewer employees to open-enrollment programs than they did five years ago, citing an unclear return on the investment and courses that are too generic and therefore not helpful enough once an employee is back on the job. But rather than abandon training altogether, some 50% of respondents said they were sending more people to customized programs. These programs

can take weeks or months to design and are typically focused on a company's particular problem, challenge, or leadership goal. Examples are tailored to a company's industry and circumstances, coursework asks participants to tackle real problems, and employees attend with their peers.

As more and more companies are turning to such programs, B-schools and other exec ed providers are scrambling to meet their needs—and employers are increasingly shopping around for the provider with the best deals. It's not unusual, say exec ed

The 20 BEST Executive Education Programs

This year, *BusinessWeek* splits the Executive Education ranking: open enrollment programs, open to participants from a variety of companies, and custom programs, designed specifically for one company. Below are the best in both, according to a global survey of corporate managers and human resource executives.

OPEN ENROLLMENT					CUSTOMIZED CURRICULUM				
RANK	PROVIDER/ LOCATION	2002-03 TOTAL REVENUE* MILLIONS	OPEN PROGRAMS OFFERED	FIVE-YEAR REVENUE CHANGE	RANK	PROVIDER/ LOCATION PROGRAMS	% REVENUE FROM CUSTOM	REVENUE MILLIONS	NO. CLIENTS SERVED 02-03
1	Harvard Boston	\$67.0	80	33.9%	1	Duke Corporate Ed.** Durham, N.C.	100%	\$24.0	32
2	Pennsylvania (Wharton) Philadelphia	37.7	116	31.3	2	Harvard Boston	21	14.7	24
3	Michigan Ann Arbor, Mich.	20.5	74	-15.6	3	IMD Lausanne, Switzerland	50	28.7	70
4	Center for Creative Leadership Greensboro, N.C.	46.2	417	8.5	4	Pennsylvania (Wharton) Philadelphia	48	18.1	54
5	INSEAD France/Singapore	67.2	117	68.0	5	INSEAD France/Singapore	48	32.2	69
6	Stanford Palo Alto, Calif.	16.5	35	46.0	6	Virginia (Darden) Charlottesville, Va.	54	8.4	17
7	Columbia New York	17.4	79	27.9	7	Center for Creative Leadership Greensboro, N.C.	48	22.2	173
8	IMD Lausanne, Switzerland	57.4	80	73.4	8	Northwestern (Kellogg) Evanston, Ill.	50	NA	29
9	Northwestern (Kellogg) Evanston, Ill.	NA	112	NA	9	Michigan Ann Arbor, Mich.	19	3.9	24
10	London Business School London	18.8	156	116.0	10	Babson (Olin) Wellesley, Mass.	82	5.5	37
11	Virginia (Darden) Charlottesville, Va.	15.4	58	-1.9	11	Columbia New York	37	6.4	18
12	Chicago Chicago	10.5	28	343.0	12	Thunderbird Glendale, Ariz.	73	7.8	133
13	Thunderbird Glendale, Ariz.	10.7	245	-4.5	13	Stanford Palo Alto, Calif.	19	3.1	6
14	American Management Assoc. New York	NA	NA	NA	14	London Business School London	55	10.3	50
15	Case Western Reserve (Weatherhead) Cleveland	2.3	59	121.0	15	Dartmouth (Tuck) Hanover, N.H.	36	2.0	14
16	MIT (Sloan) Cambridge, Mass.	11.1	28	171.0	16	Indiana (Kelley) Bloomington, Ind.	100	2.0	31
17	Duke (Fuqua)** Durham, N.C.	2.1	36	NA	17	Ashridge Hertfordshire, England	54	16.3	106
18	IESE Barcelona	30.0	124	NA	18	Toronto (Rotman) Toronto	50	2.5	10
19	NYU (Stern) New York	NA	25	NA	19	Case Western Reserve (Weatherhead) Cleveland	55	1.3	11
20	UNC (Kenan-Flagler) Chapel Hill, N.C.	8.3	44	48.0	20	NYU (Stern) New York	60	NA	10

Rankings were determined by the results of an online survey. *BusinessWeek* sent to 337 companies, 134 responded (40%). Companies indicated familiarity with both university and private-sector providers and ranked them in order of best program overall for both custom and open enrollment programs. A No. 1 ranking was assigned 10 points, No. 2 nine points, etc. To compute the ranking, the total score for a school/provider was multiplied by the number of companies ranking it and divided by the number of companies that indicated familiarity. Schools/providers ranked too infrequently by companies were disqualified. The survey was administered by and rankings were tabulated by Cambria Consulting Inc.

*Includes all custom and open enrollment revenues

**Duke's custom executive education programs are run through Duke Corporate Education, a for-profit company, but five years ago, the two branches reported revenues together

Data: Cambria Consulting Inc.; *BusinessWeek*; Research by Susannah Chen, Kate Hazelwood, Jennifer Merritt, Jessica Loudon

AT&T Wireless

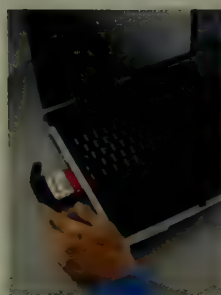
Average
20-40 Kbps

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Average
50-70 Kbps

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program directors, for a company to ask for proposals from a dozen or more schools.

That's why, for the first time, *BusinessWeek* was able to rank the Top 20 programs in each category. This year saw huge momentum for providers of customized executive education—with full programs that can cost \$5,000 to \$10,000 per participant for a weeklong course. For the Top 20 providers on our list, custom programs were often more than 50% of revenues, topping \$190 million.

Atop the new customized-curriculum ranking is Duke Corporate Education, the for-profit spin-off of Duke University's Fuqua School of Business, which handles all of the customized programs for the university. Not too shabby for a company that last year—despite good reviews from clients—looked as if it might have to fold itself back into the university because of sagging revenues and a slump in the executive education market. But President Blair Shepard was able to persuade administrators to give him more time.

The wait for a better climate may be paying off. Now, Duke Corporate Ed. takes in more revenue than all but two other schools on the list and has wooed some B-school professors to come work for the group full time. "We are to a business school what a university [teaching] hospital is to a medical school," says Shepard, adding that Duke Corporate Ed. is made up of 60% academics and 40% experienced managers. That mix allows for a successful melding of theory and practice. Duke Corporate Ed. won high praise from clients who say the group has helped them with everything from transforming strategies to integrating disparate cultures after business units have merged. For the 2002-03 fiscal year, the group made money for the first time and raked in \$24 million in revenue, up from the \$8 million it took with it from the university in the spin-off three years ago.

Harvard took the No. 2 spot in the custom ranking, winning kudos from clients for its extensive online tools, called Harvard Manage Mentor, helpful lessons on management and leadership, and courses and lectures by its marquee faculty, such as always-in-demand innovation guru, operations management professor Clayton M. Christensen. Also available to corporate clients: Coursework and notes are posted online after they complete their program. At No. 3 on the list is Switzerland's IMD, which served 70 clients last year and was cited for its global business and leadership courses.

NEEDED: LEADERSHIP

A NUMBER OF EXEC ED PROVIDERS, including Harvard, Wharton, Northwestern University's Kellogg School of Man-

RAISON D'ETRE

Companies send employees to executive education for all kinds of reasons. The top five, according to corporate respondents:

- 1 Executive education is an important training tool
- 2 Company is emphasizing management development
- 3 Such programs are necessary for succession planning
- 4 Believe payback on such executive programs is high
- 5 New workplace challenges demand different skills

Data: BusinessWeek Executive Education Survey

development at publisher and financial information company, Thomson Corp., which handles much of its training in-house but occasionally supplements with outside coursework.

Unlike a B-school, CCL focuses only on corporate leadership issues, skipping the hard-core academic lessons. Over the past two years, what with the spate of corporate scandals and profits in peril in many industries, "there has been a lot of interest in leadership development as a strategic imperative," says CCL President John R. Alexander. CCL offers more than 400 open programs per year but almost half its revenues last year came from its custom programs, designed for more than 170 clients in 2002-2003. What are custom clients asking for most? Development of "bench strength" to take future leadership roles in their companies, and assistance in stimulating innovation and creativity, particularly coming out of recession.

That's a trend that plays out across industries, from high-tech to manufacturing to consumer-goods companies. And scuttling executive development altogether because of tough times is a mistake, say some. "The economic marketplace and challenges [for business] are different than anything we've experienced in a decade," says Roseanna de Maria, a corporate consultant and former head of executive education at Merrill Lynch & Co. "So, for corporations, the training becomes critical for...profitability."

That idea is sinking in as companies slowly start to sign up again to executive education programs. Managers slashed executive education spending over the past few years are finally rethinking their budgets. Sure, that's good news for the B-schools, but it could also offer a much-needed boost to corporations trying to stay afloat through still-challenging times. ■

BusinessWeek online For more than 300 profiles of executive education and executive MBA programs, visit www.businessweek.com/bschools. While there, try out our MBA Insider, a road map for applying and getting into B-school.

QUALITY Control

Companies rated the current quality of executive education programs as compared with five years ago. Custom programs outpaced open-enrollment courses.

	BETTER	WORSE	THE SAME
CUSTOM	78.1%	1.0%	21.0%
OPEN	54.4%	4.4%	41.2%

Data: BusinessWeek Executive Education Survey

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TURBOCHARGING YOUR CAREER

As executive MBA students foot more of the bill themselves, they're also demanding more. Which schools deliver?

BY THE AGE OF 35, PATRICK DAVENPORT HAD AN impressive résumé. The former vice-president for corporate finance at GE Capital (GE) was running his own venture-capital firm that helped fund technology companies such as a component manufacturer that Intel (INTC) Corp. snapped up for \$400 million. And, with a master's degree in finance under his belt, Davenport would seem to have little use for an MBA.

But there were gaps in his knowledge, he says, such as marketing skills and the ability to inspire teamwork. At the same time, Davenport was reluctant to take two years off to attend a full-time MBA program. So instead, he applied to Northwestern University's Kellogg School of Management Executive MBA program, figuring he could continue to run his 25 portfolio companies while he studied and attended classes every other weekend. Now, five months after graduation, he's leaving venture capital to start an investment fund in real estate. It's something he knows little about, but he's not worried. "I've got a Kellogg [education as a] foundation for everything I'll do from here on out," says Davenport.

It's that kind of sentiment that propelled Kellogg into the No.1 spot once again in *BusinessWeek's* biennial ranking of the best Executive MBA programs. Grads were quick to credit a faculty that balanced academics and high-level work experience—and knew how to incorporate students' own experience and insight

into the curriculum. Just as important, as with most of the top EMBA programs, Northwestern's EMBA faculty includes the top professors in Kellogg's full-time program, not just adjuncts or less-seasoned faculty members.

When EMBA programs got their start 30 years ago, the purpose was clear: to provide corporations with a way to beef up their high-performance execs' finance, marketing, and general-management skills without losing them to full-time MBA programs or other employers. Corporations provided time off from work and footed the bill. The schools were delighted; the pricey programs were cash cows, and companies, not students, were the real clients. There was also, however, an unspoken assumption that the execs were more concerned with the credential than the content and were willing to earn a lower-calorie MBA.

That picture has changed dramatically. Cost-conscious employers are cutting back, and today, many EMBA students are paying for a big chunk of their tuition themselves. Only 42% of respondents this year were entirely compa-

Head of the CLASS

EMBA grads ranked these schools tops by subject area

*Schools not in the Top 25 but with statistically valid response rates are eligible for subject-area ratings

STRATEGY

Georgetown
Vanderbilt
Toronto*
UNC
Emory

FINANCE

Chicago-Barcelona
Rochester*
Columbia
Chicago
Notre Dame*

MARKETING

Kellogg
Duke-Global
UNC
Case Western
UCLA

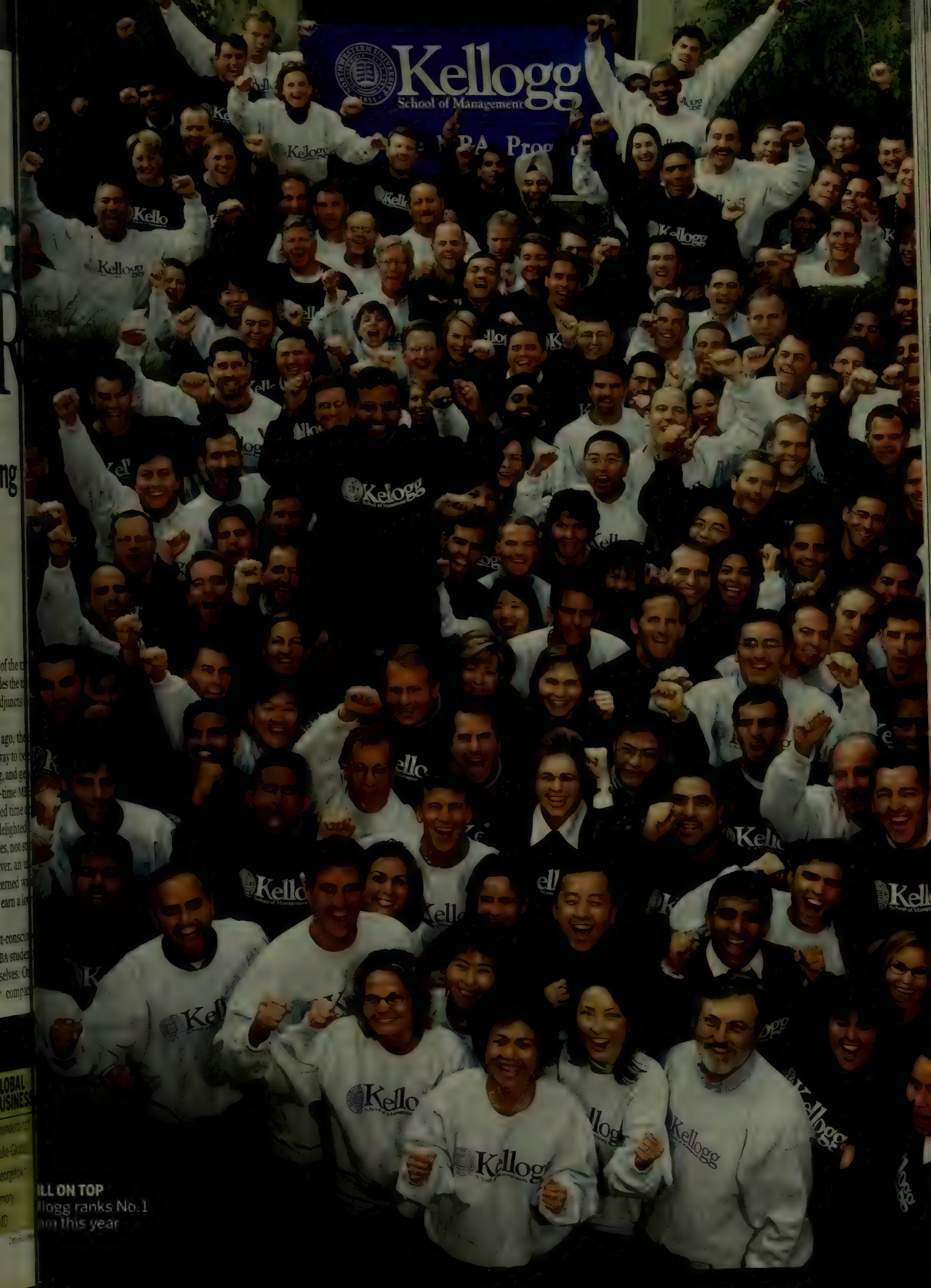
ETHICS

Kellogg
UNC
Georgia State
Texas-Austin
Chicago

GLOBAL BUSINESS

Thunderbird*
Duke-Global
Georgetown
Emory
IMD

Data: BusinessWeek



Kellogg
School of Management

MBA Program

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ALL ON TOP
Kellogg ranks No. 1
this year

sponsored—a drop from 52% in 2001. And 21% paid for the degree entirely themselves, up from 16% in 2001. That's a substantial sum considering that tuition for the two-year programs can run more than \$100,000. The trend shows no sign of slowing, either. Fully 50% of current EMBA students at the University of California at Los Angeles' Anderson School of Management, for example, are paying 100% of the bill this year. "We've never seen anything like it," says George T. Geis, associate dean and director of the EMBA program at UCLA.

It's no surprise, with students shelling out so much more, that they're also demanding more. They're insisting on quality

teaching, rigorous course work, and more services and support in such matters as travel, housing, and scheduling. One big complaint this year: Most schools don't provide adequate career services, given the price-tag (page 98).

Schools at the top of the list excel at satisfying many of these new demands. To determine the best Executive MBA program *BusinessWeek* worked with Cambria Consulting Inc. to survey more than 4,000 alumni from the 2003 graduating class, garnering a 65% response rate. We also surveyed 64 EMBA program directors, receiving a 72% response rate. The grads' survey asked about everything from quality of teaching

The Top 25 EMBA Programs

2003 RANK	SCHOOL	2001 RANK	GRAD POLL	DIRECTOR POLL	TOTAL* TUITION	ENROLLMENT** WOMEN	MINORITIES	GRADS' YR MGMT
1	Northwestern (Kellogg) Evanston, Ill.	1	5	2	\$108,000	18%	7%	11
2	Chicago Chicago	2	4	3	96,000	16	14	11
3	Pennsylvania (Wharton) Philadelphia	3	10	1	115,800	16	3	7
4	Duke (Fuqua-Weekend) Durham, N.C.	4	20	4	79,500	13	4	8
5	UNC (Kenan-Flagler) Chapel Hill, N.C.	5	3	9	57,000	15	5	8
6	IMD Lausanne, Switzerland	13	5	12	83,950	12	NA	10
7	UCLA (Anderson) Los Angeles	10	8	7	70,000	28	12	10
8	Texas (McCombs) Austin	12	2	20	62,800	11	1	6
9	Duke (Fuqua-Global) Durham, Germany	NA	1	18	104,030	21	19	11
10	Emory (Goizueta) Atlanta	8	9	9	70,364	23	11	8
11	Georgetown (McDonough) Washington, D.C.	9	11	24	70,450	23	10	8
12	USC (Marshall) Los Angeles	6	22	8	74,200	22	9	11
13	NYU (Stern) New York	7	35	5	105,000	33	4	7
14	Cornell (Johnson) Ithaca, N.Y.	NA	12	20	102,800	15	12	9
15	Columbia New York	18	15	6	112,200	15	3	6
16	Purdue (Krannert) West Lafayette, Ind.	14	19	27	48,000	20	14	8
17	Washington (Olin) St. Louis	16	16	15	84,500	22	9	8
18	SMU (Cox) Dallas	19	13	22	63,550	20	10	10
19	Pepperdine (Graziadio) Culver City, Calif.	11	24	36	71,500	26	15	8
20	Vanderbilt (Owen) Nashville	17	18	32	69,500	25	8	8
21	Case Western Reserve Cleveland	NA	7	17	75,000	18	5	13
22	Chicago-Europe Barcelona	NA	14	28	79,500	11	NA	9
23	London Business School London	23	25	11	62,775	24	NA	6
24	Georgia State (Robinson) Atlanta	20	24	20	50,500	25	21	9
25	Western Ontario (Ivey) Mississauga, Ont.	15	26	18	54,750	20	NA	9

* Provided by business schools; tuition figures for out-of-state residents where applicable. ** Provided by business schools; enrollment figures are for most recent class. *** Based on compilation of EMBA graduate responses; top 20% in each category of students get As. The next 25% get Bs. The next 35% are awarded Cs. Where there is inadequate information in a category, schools receive NA. Questions represent only part of the total survey results. More results can be found at www.businessweek.com/bcschools/. Data: BusinessWeek, Cambria Consulting Inc. Research by Kate Hazelwood, Jennifer Merritt, Susannah Chen, Frederick Jesp.

effectiveness of support staff. Schools with too few responses were disqualified. Program directors were asked to list the 10 schools, excluding their own, that offer the highest-quality programs. The directors' and students' surveys each contributed 50% of the total score. Graduate scores from 2003 counted as two-thirds of the total grad score. The scores from the last survey in 2001 made up the balance. We standardized the scores from both surveys and tallied them for a ranking.

Just behind Kellogg, holding the No. 2 spot, is neighboring University of Chicago Graduate School of Business. Chicago graduates raved about the program's international focus—un-

usual in a U.S. program—in which students from the school's Barcelona, Singapore, and Chicago programs meet in each country for a week, in addition to their time in their own program. Dissatisfaction centered around what students perceived as an overconcentration in finance. ("It should be labeled an EMBAF, an executive MBA in finance," gripes one alum.) But most respondents gave the school high marks for an environment that is more collegial and fun than they had expected from a school with such a serious quantitative focus. The University of Pennsylvania's Wharton School landed at No. 3. Graduates praised its high-level faculty and the power of the Wharton brand, and the directors' poll ranked the school No. 1.

Completing the top five were other familiar names: Duke University Fuqua School of Business' weekend program placed No. 4, with students lauding a rigorous program and nurturing faculty. Students at No. 5, the University of North Carolina's Kenan-Flagler Business School, cited top-flight professors.

NEW FOCUS

STILL, IT HASN'T BEEN an easy road for the 2003 EMBA grads. They started their degrees at a time when there were plenty of real-time crises to bring into the classroom. "Soft" topics such as leadership, crisis management, and ethics became hot as the shock of September 11 was followed by sobering corporate misdeeds, while an economy in freefall threatened to take EMBA students' jobs with it—and often succeeded. Some schools' faculties worked current events and economic news into their lesson plans, a move students say they appreciated.

Now that they're juggling tuition along with full-time jobs, personal lives, and a course load that might include hours of commuting time, EMBA students are ratcheting up more than just their academic expectations. They also want smooth logistics so they can concentrate on school, work, and family rather than plane tickets, meals, and books. EMBA students also prefer to be around high-level classmates who have a string of professional successes already behind them.

They also crave an academic challenge. Students gave the highest marks to the programs that they considered to be the most rigorous. Cornell University, eligible for the EMBA rankings for the first time this year, entered the list at No. 14, with grads praising the school for its intensity even as they said it made for a challenging two years. "It was hard to digest, say, the entire Cost Accounting syllabus into a three-weekend course," says one alum.

Some schools are trying to deliver that rigor in a distinctive package. Duke's

SCHOOL GRADED BY GRADS***

RANKING	CURRICULUM	SUPPORT	DESCRIPTION
1	B	A	Grads praise emphasis on teamwork and laud accessible faculty for its balance of business experience and theory
2	A	A	Grads say international aspect of a U.S. program differentiates it from other programs, and give high marks for sense of community
3	B	B	No. 1 in Directors Poll; grads say large class size doesn't merit high tuition but praise program's rigor and reputation
4	B	C	Grads praise discussion and coursework precisely tailored to exec-level students; strong emphasis on community, family, and ethics
5	A	A	Staff highly responsive to student suggestions and complaints; grads say faculty are tops in their fields
6	A	B	The most international of all the top programs; module approach provides for immediate real-world application of coursework
7	A	A	Grads rave about tuition-free access to classes post-graduation and laud comprehensive field-study program, faculty with executive experience
8	A	A	High marks for teaching quality and support, and a curriculum immediately applicable at work—at a competitive price
9	A	B	Two-week foreign residency each semester augmented by teleconferencing and distance learning praised as highly effective
10	B	A	Shorter program—16 months rather than 20—requires immediate acclimation; students note well-connected faculty
11	A	C	Grads laud largely ego-free faculty's dedication, enthusiasm, and surprising expertise in a "nonbusiness" town
12	C	B	Grads concerned by outdated materials; praise excellent support staff and accessible faculty; opinions vary widely on caliber of student body
13	C	B	Standout adjuncts receive high praise, but fellow students do not; grads note need for tougher acceptance standards
14	B	B	Off-campus location near NYC presents inherent difficulties for commuters and professors; grads praise curriculum and faculty
15	B	C	School maximizes NYC location, with impressive roster of business leaders as adjuncts; grads praise responsive administration
16	C	C	Grads note faculty's ability to incorporate current events into curriculum, praise faculty as accessible and engaged
17	B	A	Faculty praised for being enthusiastic and available, and leaders in their fields; grads say school is underrated because of Midwest location
18	B	B	Grads praise quality of teaching and professors but want tougher admissions standards for better-caliber classmates
19	A	D	Grads say poor interfaculty communication causes glitches between classes; praise strategy, analytics, and a lively curriculum in general
20	B	C	Grads praise excellent faculty with just a few exceptions; grads are enthusiastic and note highly recommending school to peers
21	B	A	Consistent praise for curriculum, support staff, and an enthusiastic, well-rounded faculty made this school a new entry
22	A	C	Grads rave about weeks in Chicago and Singapore but want more inclusion of European and Asian business practices
23	C	D	Grads laud high caliber of a very international student body; some professors unskilled with executive-level students
24	B	D	Grads appreciate practical emphasis of program; evaluation of instructors varies widely; students want more top-tier guest lecturers
25	NA	D	Faculty praised for real-world and consulting experience, but grads want newer case studies and teaching aimed at executives

Fuqua Global Executive program, which alternates periodic one- and two-week international residencies in Durham and Germany with distance learning, earned kudos from students for its academics and for simulating the global workplace through teleconferences and team projects that spanned different time zones and languages. The combination is working: Duke's Global Executive program comes in at No.9—and unlike other EMBA hybrid programs, the Global Executive program also won praise from EMBA directors.

TURNAROUND

MORE TRADITIONAL international programs also continued to impress, as well. Small classes and discovery trips to Shanghai, Dublin, and Silicon Valley helped IMD in Lausanne, Switzerland, secure the highest spot in the rankings of any international school, at No. 6. And the University of Chicago's Barcelona program, which uses the same faculty as Chicago's full-time and other EMBA programs, entered the rankings this year for the first time, at No. 22.

Columbia University, a lackluster entrant in 2001 whose grads then claimed the lowest satisfaction level of any of the Top 25 EMBA programs, managed to pull off a turnaround—at No. 15 in the overall rankings and No. 15 in student satisfaction. The difference this year? Grads say the school responded with more than lip service to the class of 2001's complaints by increasing administrative support. Alums also lauded the program for its roster of high achievers that rallied around classmates who lost friends and family on September 11. One change they fiercely oppose, though: Columbia's move from meeting every Friday to meeting every other Friday and Saturday, a schedule that now resembles that of most other EMBA programs. Grads say the switch makes an EMBA less manageable for students with families.

EMBA's are a breed apart. They identify heavily with their executive-level responsibility and status—and they value a topflight faculty and student body that reflect those lofty heights. They're also sensitive to criticism that EMBA's earn an "MBA lite" and want to be taught at an even higher and more sophisticated level than their younger, less experienced, full-time counterparts. The schools that address these issues head-on remain the best of the bunch. ■

—By Kate Hazelwood in New York

COMMENTARY

BY SUSANNAH CHEN

You Don't Get What You Pay For

B-schools give EMBA's little help in job searches.

AFTER GRADUATING from the executive MBA program at the University of North Carolina's Kenan-Flagler Business School in May, Nicole Benedict found a job with "the perfect fit," as a manager of customer service at art.com, an online retailer. But one thing still rankles: Her alma mater provided no help in finding the job. In fact, its career resources were off limits to EMBA students. Benedict paid for her \$51,000 degree herself, with no support from her ex-employer, yet the school said she was on her own in her job search.

Of the EMBA alums who responded to *BusinessWeek's* survey, Benedict is one of the 31% whose companies paid less than 20% or nothing at all toward their degree. Paying students—with tabs between \$50,000 and \$100,000—have much the same expectations for the mid-career program as daytime MBAs do. Problem is, the schools haven't caught up with the new reality. Only one-third of survey respondents said they had access to their B-school's career services—and many reported that access ended at job postings. "The [self-sponsored] EMBA student is left in the cold," complains Benedict.

UNC officials say they will now offer EMBA grads limited access to career services, but not many schools are following suit. The resistance to opening the doors for EMBA's has more to do with the past than the present. Historically, almost all EMBA students were supported by employers. Giving career

advice to students whose companies pay their way was and is still a no-no for preserving corporate relationships.

But schools that keep ignoring the needs of the growing ranks of self-sponsored students are missing an opportunity. EMBA grads are a powerful group of experienced managers—many with 10 or more years under their belts—who could be conduits to jobs for a school's MBAs and undergrads. If the career office helps them find satisfying jobs, EMBA will be more likely to steer their companies toward their alma maters, spending executive-education dollars.

Teaming up with an executive search firm is one way to find fitting jobs for more seasoned EMBA students. Another is to make key MBA employers aware that EMBA students

Footling the BILL

EMBA grads are paying for more of their tuition than in 2001

2001	2003
EMPLOYERS PAY NOTHING OR LESS THAN 20%	
16%	31%

Data: BusinessWeek Executive MBA graduate surveys

are available for senior-level jobs—simply lumping EMBA students in with younger grads won't be enough.

B-schools have changed over the decades and now have multiple constituencies. EMBA's are a growing cohort, and helping them with their careers could plump the corporate Rolodex and lead to jobs for other types of B-school students. That's an equation any MBA can understand. ■

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A Whole New Ball Game?

The push to reform—and scale back—collegiate athletics is gaining yardage

A GLORIOUS AUTUMN day. School colors flying. Bands blaring fight songs. Cheerleaders in skimpy skirts kicking up their heels. Stands vibrating from the stomping feet of fans. Fearsome young men raging with the fire of competition. Isn't this what college is all about?

Er...not according to a killjoy named Gordon Gee. In September, Vanderbilt Chancellor Gee grabbed headlines when he announced that he was disbanding the university's athletic department. Granted, no teams were cut, no athletic scholarships lost. But Gee did strike a chord. In trying to pull the athlete back into the academic community, he became the public face of a movement that is making a seri-

ous stab at reforming college sports. "Other universities have called and said, 'Good, you jump off that cliff, and if it works, get back to me,'" says Gee. "I suspect they're sweating bullets, with all the national attention."

Why? Because Gee's success or failure just might help foretell the future of extracurricular activity that has grown into a \$3 billion-a-year annual industry, according to Smith College economist Andrew S. Zimbalist, author of *Unprofessional*. Behind the crowds and the hype, pressure is building either to turn class-skipping athletes into students or to recognize that—at least at big-time sports schools—it's too late to turn back the clock. And that's pitting reformers against an army of alumni boosters, politicians who control state schools, networks, and commercial interests—of whom would feel the impact of downsizing college sports.

The endless debate over the proper role of sports in university life would probably not be raging so fiercely if it weren't for particularly troubling spate of scandals. Months after Maurice Claret led Ol



MICHIGAN College athletics is now a \$3 billion-a-year industry

And it isn't just the players. Georgia basketball coach Jim Harrick resigned amid charges of academic fraud. Alaba-

ma fired head football coach Mike Price for "indecorous" behavior involving a drinking spree and a stripper. Iowa State basketball coach Larry Eustachy resigned after photos surfaced showing him drinking and kissing coeds at a party after a game. Most bizarre, Baylor basketball coach Dave Bliss threw in the towel after trying to cover up illegal payments to a player—before he was murdered—by allegedly spreading rumors that he dealt drugs.

Some reforms have already been put in place: stricter academic requirements for entering freshmen and for athletes to remain eligible. Others are long-range and more ambitious. They include shortening the football and basketball seasons, and, most fundamental, pulling back from the commercial forces that have turned college sports into an entertainment spectacle.

Leading the charge are faculty senates, including many from the six athletic conferences that form the Bowl Championship Series (BCS); the powerful Association of Governing Boards of Universities & Colleges; and the National Collegiate Athletic Assn. (NCAA)—generally considered the marketing arm of college sports. "What's unusual here is having a faculty group and a trustee group aligned," says Robert Eno, co-chair of the faculty group, the Coalition on Intercollegiate Athletics (COIA), alluding to trustees' usual fervent support of athletics. "It's odd. It's unprecedented. We're all surprised, but it seems to be working well."

Crisis is nothing new to college sports. Violent deaths in football led President Teddy Roosevelt in 1905 to threaten the game's abolition, which spurred the

forming of the NCAA that same year. What's different now is the amount of money sloshing around. Schools that make it to the top bowl games can pull in up to \$13 million apiece. And in March, 1999, CBS signed an 11-year, \$6 billion TV contract, mostly for basketball. (Football contracts are awarded by individual conferences.) As a result, schedules and seasons have expanded, expenses have skyrocketed, and scandals have multiplied.

FOLLOW THE MONEY

NOW, SAYS MYLES BRAND, head of the NCAA since January, "change is in the air." Predictably, the current reform movement started over money. The coalition of faculty members was born in the fall of 2002 after a professor of classic languages at the University of Oregon, James Earl, became alarmed by a single act of university spending. "I picked up my newspaper one morning and read about the university spending \$90 million to expand the football stadium," says Earl. "The faculty had never been told about it. We went nuts. We're poor as church mice here. How could you spend \$90 million on a stadium when we can't even pay the faculty's salaries?"

Earl was then president of the Oregon faculty senate, and he wrote to the presidents of the other universities in the Pacific 10 Conference. By the beginning of 2003, faculty senates at 45 to 50 universities had contacted the COIA to voice their support. In January, the Association of Governing Boards of Universities & Colleges, the advisory group representing the trustees of over 1,200 institutions elected to join the COIA in its reform push. The final member of the triumvirate to weigh in was the NCAA. Says Brand, the first university president to head the NCAA and the man who fired basketball legend Bobby Knight at Indi-

ate to the national title in football, the nning back was charged with receiving special treatment on an exam and accused of lying to police about what was stolen from a car loaned to him by a school booster. The men's basketball am at Fresno State was put on probation after someone else did players' urse work. The University of Washington was hit with a two-year probation for recruiting violations.

Reformers Are Driving **Downfield**

Big changes in college sports are in the works. Here are some of the reformers' goals:

ALREADY HAPPENING

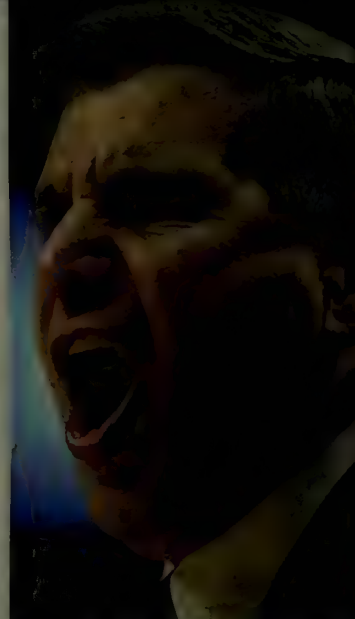
- Vanderbilt disbands its athletic department.
- Five New England colleges reduce the number of athletes they accept.
- Ivy League presidents agree to cut recruitment of athletes.
- NCAA raises academic requirements for entering freshmen athletes and stipulates progress that they must make toward graduation each year.

ON THE WAY

- A system that financially rewards teams that do well academically and punishes those doing poorly. To be voted on by Division I presidents in April.
- Having increased academic standards, the NCAA will reexamine the rules on how much time athletes can spend on their sport. It's now capped at 20 hours a week but is sporadically enforced.

MORE-RADICAL IDEAS

- More transparency in athletic department budgets.
- Elimination of athletic scholarships.
- Shorter playing seasons, smaller teams.
- Taking control of game schedules from TV networks.
- Combat commercialism by banning corporate logos on uniforms and ads in stadiums.



UNDER A CLOUD Ohio State's Clarett and former Georgia basketball coach Harrick

ana: "Reform was one of the conditions under which I took this job."

The three groups met in Chicago in April and endorsed a series of educational and budgetary reforms. Some had already been enacted by the NCAA over the previous two years, all of them aimed at improving academic performance. One rule stipulates that athletes complete a set percentage of the requirements to graduate each year. Another raises grade-point averages athletes must achieve in college, and a third boosts the academic qualifications athletes must have to enter.

The reformers also back a carrot-and-stick plan, rewarding teams that do well academically with more scholarship slots and money from television and punishing teams doing poorly by taking away scholarships and ultimately barring them from post-season play. These measures will be voted on by Division 1 presidents in April and are expected to pass. "We are also looking at the kinds of courses that student-athletes should be taking," says Brand. "We want general education courses, not any old course."

Critics, however, point out that stronger regulations aren't enough. They require accurate and honest reporting. "You can toughen up academic standards, but that leads to more academic fraud," says Howard Chudacoff, a history professor at Brown and the university's NCAA faculty representative. Brand insists that maintaining academic integrity is a primary objective and says the NCAA will modestly boost its investigative staff, which now numbers 15.

The April meeting also set longer-term

goals involving "transparency" in athletic budgets. The sources of money for college sports are often murky: Cash from boosters often goes unreported and can cover under-the-table payments to coaches and even players. Facilities can be a mystery all their own. "It's always difficult to account for capital spending, athletic or otherwise," says Brand. On Aug. 6, the NCAA received a \$50,000 grant from the Mellon Foundation to back a study of capital spending on athletics.

What's not murky is that as more money goes to new stadiums, celebrity coaches, and better training facilities, critics of the so-called "athletics arms race" have become more vocal. Some schools have independent athletic departments that support themselves, but the majority are funded by the university. "About 30 schools have separate athletic budgets," says reformer Earl, but around 100 in Division 1 are "sucking money from the schools."

And it isn't just the money that bothers the reformers but the deals made to get that money—like the Nike swoosh on uniforms at many schools and ads on arena walls. "That's an unpleasant message to a lot of people who care about the idea of the university as a place of inquiry free of commercial taint," says Derek Bok, former president of Harvard and author of *Universities in the Marketplace*.

The reformers are also training their guns on what may be the most powerful

force in today's college sports landscape: television. They believe that TV's scheduling needs—games during the week, long travel to tournaments—increasingly clash with academic requirements. One of the movement's long-term goals is regaining control of schedules. They would like to see shorter seasons and smaller squads. The Drake Group, a four-year-old reform organization of about 100 due-paying professors across the country, wants "to return control of the classroom to the faculty," says its president, Lin

Bensel-Meyers of the University of Denver. The group believes many athletic departments currently have the power to get grades changed, and encourage plagiarized papers.

Major ammunition for the reform movement has come from a persuasive series of statistics—"myth-breaking," Brand calls them—that challenge the benevolent long thought to flow from

strong sports programs. One of the biggest myths was shattered when Brand announced in August that "fewer than a dozen universities" make a profit from sports. All of those were Division I schools with major basketball and football programs.

Universities that can't rely on football and men's basketball to pay the bills are often forced into painful downsizing their sports programs. Since 2000, 31 Division I schools have eliminated at least one intercollegiate sports team, accord-

Fewer than a dozen schools make a profit from athletics

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Sports Biz

to the *Chronicle of High Education*. This year, West Virginia University swung the ax at five, including men's cross-country and men's tennis.

Four studies in the past eight years—the latest by the NCAA this year—conclude that winning sports teams do not necessarily inspire alumni to donate, and in those cases when they do, the boost is short-lived. “We only saw an impact in alumni giving if a school wins a bowl game, on average 7.3%,” says economist Thomas A. Rhoads, who co-authored a 2000 study. “But when a basketball team was put on probation, there was a decrease of 13.6% in alumni contributions.”

OPEN THE DOOR

PERHAPS the most shocking findings came from a 2001 study by the Mellon Foundation that demonstrated the importance afforded athletics at Ivy League and other prestigious schools that downplay sports and profess to give no athletic scholarships. “We say we don’t give scholarships, but we really do—the whole Ivy League does,” says Brown’s Chudacoff. “We give money to needy students, and we have a lot of needy athletes.” The Mellon report revealed that nearly all top schools also lowered admission standards for athletes, opening the door more readily for jocks than for minorities or the children of alumni. Once enrolled, athletes do more poorly than nonathletes—as much as 20% worse.

“It makes it harder for faculty to teach the way they want to teach because they don’t get the commitment or the preparation from the recruited athletes that they get from the other students,” says William G. Bowen, head of the Mellon Foundation and co-author of two books based on the study. Bowen adds that nonathletes resent what they see as domination of the campus by athletes, who can make up as much as 35% to 40% of the student body of smaller schools, compared with about 3% at big state universities. The result, he says is “an athletic divide.”

Some schools have already taken action to rein in sports. Boston University dropped football in 1997 after 113 years and Swarthmore ended a 122-year football tradition in 2000—both citing an overconcentration on sports. In 2002, 5 of the 11 members of the New England Small College Athletic Conference (NESCAC) decided to reduce the number

of athletes it accepted and the Council of Ivy League Presidents in June voted for the first time to limit the athletes its eight universities can recruit.

“We were willing to trade off SATs and GPAs to get a kid who’s a great violinist or a student of color, but we were more willing to make that trade-off for athletes,” says President Morton O. Schapiro of Williams, which voted for the NESCAC cuts.

How many schools will follow suit remains to be seen—and some of the reformers’ proposals clearly amount to pigskin in the sky. Many university leaders argue that the benefit of a major sports program still far outweighs the drawbacks. “The idea of sports is to shine a light on the university in a positive manner and to help enrollment,” says Robert J. Dwyer, chairman of the board of trustees of Niagara University and 1965 graduate who helped fund the school’s first hockey rink. “Our [men’s hockey team] went to the Final Eight

2000, and our women to the Final Four 2002. Enrollment has risen steadily.”

RABID FANS

BESIDES, COLLEGE SPORTS are deeply woven into America’s tapestry. “Sports offers high visibility that in some mysterious way creates a bond between the university and a broader public,” says James Duderstadt, former president of the University of Michigan. The pull of collegiate sports has on the populace especially true at state schools, where traditions are storied and fans rabid. It was no accident that Gee waited until he had left his previous positions at Oklahoma State, Colorado, and West Virginia before

Who's Tops In Alumni Giving?*

It's not all big-time sports schools

USC	\$585.2 million
HARVARD	\$477.6
STANFORD	\$454.8
CORNELL	\$363
UNIVERSITY OF PENNSYLVANIA	\$319.7
JOHNS HOPKINS	\$318.7
UNIVERSITY OF WISCONSIN	\$307.2
UNIVERSITY OF CALIFORNIA	\$282.3

*Totals include all private giving for 2002
Data: RAND's Council for Aid to Education

re making his stand at private Vander-
lt. "If I were to try to do this at Ohio
ate," says Gee, "I would end up pump-
g gas."

And it is not just emotions that are at
ay at state schools but money and poli-
es. The governor and legislatures con-
ol school budgets, and they stand for
ection answerable to a sports-crazed
ectorate. "Because the state has deeper
ockets than any single institution, state
iversities are more likely to spring for
w facilities," says sports economist
mbalist. "Once that investment is
ade, perhaps hundreds of millions of
ollars, it ups the pressure to win."

That's why many think the reform
ovement will get nowhere—at least at
g-time sports schools. "I can't believe
at a Michigan or a Penn State, schools
th good academics and successful
orts programs, are going to want to
t back," says Bill Cella, chairman of
agna Global USA, the TV negotiating
in of the communications conglomer-
e Interpublic Group. "I think the re-
erse is happening. There are efforts
w on behalf of the networks to con-
vince the [BCS] conference to go into a
al playoff structure. That would gener-



MAVERICK
Vanderbilt's
Gee did away
with the
athletic
department

sponsorship and advertising could go
up," he points out.

The question is: Where is it all going
to end? Reformer Eno sees a nightmarish
future: "If the situation continues to
evolve the way it has," he says, "there's

ate some real money,
and money rules the
day." Zimbalist adds
that shortening seasons
might not loosen mon-
ey's grip: "With less
supply, the price for

from bowl games, TV, and endorsements.
The NCAA firmly opposes "pay-for-play"
but is studying a plan to increase scholar-
ship support.

"We're at a crossroads," says Brand. "If
this reform fails and schools adopt a pay-
for-play professional model, it is the end
of college sports as we know it and a seri-
ous loss to the educational system."
That's why the reformers plan to keep
grinding it out on the ground until they
make some serious yardage. ■

—By Skip Rozin, with Susan Zegel

MARK HUMPHREY/AP/WIDE WORLD

► HOLD UP TO MIRROR ANSWER HONESTLY. ◀

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UnMarried America

Say good-bye to the traditional family. Here's how the new demographics will change business and society. **BY MICHELLE CONLIN**

MOST THURSDAY NIGHTS, HILLARY HERSKOWITZ slips on her Seven jeans, chooses from among her dozens of shoes, and steps out for an evening sipping Ketel One an tonics with the modish throngs of Manhattan. The 35-year-old communications director and her designer-clad wing girls—a pediatrician, a health-care manager, and an executive recruiter—cruise the city's swankiest bashes: the posh private parties, the paparazzi-stalked soirees. They don't just watch *Sex and the City*. They live it.

But after 13 years of this behind-the-velvet-ropes scene, they have yet to find the one thing they want most: husbands. The search has taken on a more desperate flavor of late; the women now plan to haunt sports bars in their stilettos. "It feels terrifying because the biological clock is ticking, and I want to have kids," says Herskowitz. "And I never, ever thought I'd wind up here."

Thirty years ago, a single woman like Herskowitz would have been considered an aberration. An old maid. Today, she's so typical that the highest IQs in Hollywood and on Wall Street and Madison Avenue are fixated on dreaming up products for the swelling ranks of unattached urbanites just like her. Add to these monied romantics a growing number of gay couples such as Luke Schemmel and Jonathan Shapiro, who are raising two adopted kids; divorced parents such as Jason Lauer and Terresa Lauer, who share custody of their 7-year-old son; single parents like Mark Cunha, a widower who is raising a son and daughter alone; and young men like Vincent Ciaccio, who broke his Italian mother's

heart when he got a vasectomy three years ago at the age of 23 because he didn't want to get tied down. Along with the growing numbers of cohabitants and elderly unmarrieds, these wildly divergent types are the force behind a huge demographic shift taking place in this country: We're on the verge of becoming—at least in the legal sense—a nation of singletons.

The U.S. Census Bureau's newest numbers show that married-couple households—the dominant cohort since the country's founding—have slipped from nearly 80% in the 1950s to just 50.7% today. That means that the U.S.'s 86 million single adults could soon define the new majority. Already, unmarrieds make up 42% of the workforce, 40% of home buyers, 35% of voters, and one of the most potent, pluralistic—consumer groups on record.

Yet even as marriage is on the wane, infatuation with the institution has never seemed so fierce—from the debate over same-sex unions to President Bush's marriage-promotion campaign to reality TV's depiction of wedlock as a psychological



ME-SEX PARTNERS

... couples such as
... e Schemmel and
... athan Shapiro are
... ing adopted children
... forming de facto
... ilies—whether
... marriage laws
... knowledge the
... ity or not

DIVORCED

Terresa Lauer and Jason Lauer of Santa Cruz, Calif., share custody of their son, Joss

Super Bowl. The culture may be so marriage-crazed, though, precisely because the rite is so threatened. Indeed, we are delaying marriage longer than ever, cohabiting in greater numbers, forming more same-sex partnerships, living far longer, and remarrying less after we split up (charts).

What many once thought of as the fringe is becoming the new normal. Families consisting of breadwinner dads and stay-at-home moms now account for just one-tenth of all households. Married couples with kids, which made up nearly every residence a century ago, now total just 25%—with the number projected to drop to 20% by 2010, says the Census Bureau. By then, nearly 30% of homes will be inhabited by someone who lives alone.

This unprecedented demographic shift holds vast implications for everything from Corporate America to the culture wars; from government institutions to the legal system. Vast swaths of our social infrastructure are still modeled on the days when our realities were reflected in *Leave It to Beaver*, not *Queer Eye for the Straight Guy*. Corporate benefits, pensions, taxes, Social Security, educational funding—all were designed in the last century to favor and encourage marital unions. “There’s this pervasive idea in America that puts marriage and family at the center of everyone’s lives,” says Bella M. DePaulo, visiting professor of psychology at the University of California at Santa Barbara, “when in fact it’s becoming less and less so.”

So societally ingrained is matrimony that on their wedding



day, a bride and groom become immediately eligible for a bonanza of perks. The notion that married people lose out because they pay more in taxes through the oft-cited marriage penalty is only partly true. Dual-income, high-earning marrieds and low-income couples sometimes suffer the penalty, but for slightly more than half of all spouses, marriage actually slashes tax bills, particularly for those with children. That means, for example, that mega-salary executives who stay-at-home wives get subsidized that single working mothers don't. “It does seem unfair to me that there are single people in our exact same situation who pay more than we do in taxes,” says Scott Houser, a tax-code expert and economics professor at California State University at Fresno. “Fixing the marriage penalty is just going to make the single penalties worse.”

Indeed, the elements are in place for a new form of social warfare. That's because what's occurring is a wealth transfer to the married class, which imposes an array of unseen taxes on singles—no matter how many people they care for are dependent on them (table).

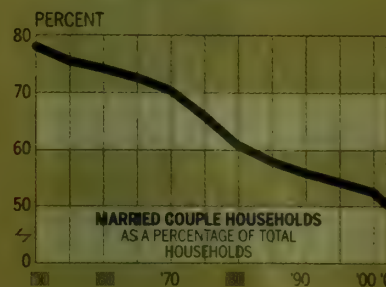
In the workplace, unmarried people wind up making an average 25% less than married colleagues for the same work because of the marriage-centric structure of health care, retirement, and other benefits, calculates Thomas F. Coon, a lawyer who heads the Los Angeles-based American Association for Single People.

In the civic arena, rising school taxes and growing inequities in pensions between marrieds and singles represent a big bonus for legal couples. The unmarried are often subjected to discrimination in housing and credit applications. They pay more for auto and homeowners' insurance and are shut out of valuable discounts on gyms, country clubs, hotels,

Unmarried: The New American Way

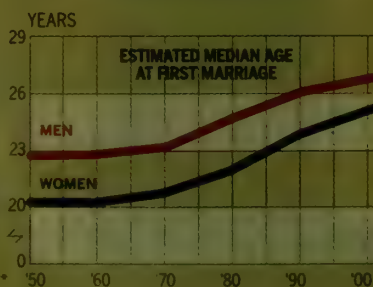
Delayed marriage, cohabitation, and longer life spans are making the married majority a thing of the past

The married majority is on its way out...

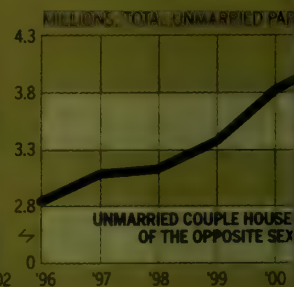


Data: U.S. Census Bureau **02 data from The American Community Survey

...because people are marrying later...



...cohabiting more...



The Unmarried Penalty

America gives traditional families all sorts of breaks. But the 86 million adults in Unmarried America—making up about half of households, 42% of employees, and 35% of voters—face big “unmarried” disadvantages:

FEWER JOB BENEFITS Companies subsidize benefits for employees' spouses and kids. But unmarried workers don't get compensated in some other form to make up the difference. For spouses, benefits are tax-free. For domestic partners, benefits get taxed (when they exist).

HIGHER UNEMPLOYMENT, LOWER PAY Unemployment for unmarried people with children under 18 was 9.1% last year—vs. just 8% for married workers with kids. **Never-married men also make less than married men,** as do unmarried women—until they hit 35, when never-married females start to earn more.

HIGHER TAXES Unmarried partners can't file joint returns. Nor may they do so with blood relatives with whom they are living and sharing expenses. They also get a smaller capital-gains break when they sell their houses.

LOWER SOCIAL SECURITY AND UNEMPLOYMENT BENEFITS Everybody pays these taxes, but **surviving spouses can**

collect half of a deceased worker's benefits, whereas domestic partners can't. Many marrieds can also collect unemployment if they quit to move with a relocated spouse.

NO ESTATE-TAX BREAKS Married people can leave spouses everything, tax-free. But estates of unmarrieds worth more than \$675,000 are taxed at 25% to 60%.

TRANSFER TAXES Transfers of property to a spouse are not taxable. Transfers to domestic partners are.

MARITAL STATUS REDLINING Many insurance companies put married drivers into a low-risk category and **unmarried drivers into a high-risk one.**

FAMILY DISCOUNTS Most country clubs, health clubs, and auto clubs allow a spouse to join free of charge or at a steep discount. But **unmarried partners must pay for two memberships.** Not to mention the “single supplement”: the 40% to 100% more that

singles pay for hotel or cruise-ship rooms that would otherwise be shared.

NO VICTIMS' RIGHTS PROTECTION If a drunk driver kills a married partner, the surviving spouse can sue for wrongful death. But **unmarried surviving partners have no legal recourse.**

CREDIT AND HOUSING DISCRIMINATION Unmarried joint applicants are sometimes **offered credit on less favorable terms** than married counterparts. Many states do not ban marital status discrimination in rental housing, allowing landlords to refuse to rent to unmarried tenants.

LACK OF CITIZENSHIP RIGHTS FOR SAME-SEX PARTNERS Fifteen countries recognize **same-sex couples for immigration.** But U.S. citizens in relationships with same-sex foreigners cannot sponsor their partners.

Data: American Association for Single People, Lesbian & Gay Immigration Rights Task Force, *BusinessWeek*

ms—even football-ticket lotteries. In some states, unmarried people, perhaps laid off from jobs and scrounging to pay their bills, are barred from taking on roommates to help pay the rent.

Outdated Definitions

THESE SILENT LEVIES MAY HAVE SEEMED LESS important the days when most homes had a working dad and a full-time mom—and kids largely resided with their two biological parents. But today, chances are that if you live to the age 70, you will spend more of your adult life single than married. Moreover, a record number of children—33%—are now born to single parents, many of them underemployed, unemployed mothers. Yet “most workplaces are still modeled on an outdated definition of an ideal worker—someone who works more than 50 hours a week and doesn't take breaks to raise children,” says Joan Williams, co-director of the Gender,

Work & Family Project at the American University Law School. “God forbid if you are single mother trying to live up to that ideal without a wife.”

As the reality of unmarried America sinks in, CEOs, politicians, and judges will be challenged to design benefits, structure taxes, and develop retirement models that more fairly match the changing population. Already in Corporate America, more than 40% of the 500 largest companies have started to revise their marriage-centric policies, reexamining everything from subsidized spousal health care to family Christmas parties. Companies such as Merrill Lynch & Co. and Bank of America have begun to accommodate the shift by instituting “extended family benefits.” These plans allow employees to add a qualified adult household member to their health plans—be it a domestic partner, extended family member, or grown child. American Express Co. is considering a plan whereby employees who are parents pay more for each kid they add to the health plan. At Xerox Corp. employees now get \$10,000 upon joining the company, on top of a standard benefits package, to spend on whichever programs they choose rather than having it automatically earmarked for families; at Prudential Securities Inc., cohabitants can get health benefits for opposite or same-sex partners as long as they've been living together at least six months.

Writ large, these kinds of changes could lead to more European-style systems that de-link marital status from eligibility for social benefits. Already, a bill is pending in Congress that would make benefits for household members and domestic partners tax-free, just as they are

splitting up in
ter numbers...

...forming non-
traditional families...

...and living longer, upping
the odds of widowhood

MEN DIVORCED*
2002
8%

GAY MALE COUPLES WITH CHILDREN* **MALE EST. LIFE EXPECTANCY AT BIRTH***
1990 2000 1950 2000
5% 22% 66 74

WOMEN DIVORCED*
2002
11%

LESBIAN COUPLES WITH CHILDREN* **FEMALE EST. LIFE EXPECTANCY AT BIRTH***
1990 2000 1950 2000
22% 34% 71 80

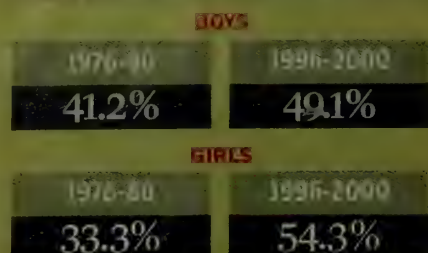
*As a percentage of all same-sex couples
Data: Urban Institute

*All races

The New Singledom is Changing How Americans Live

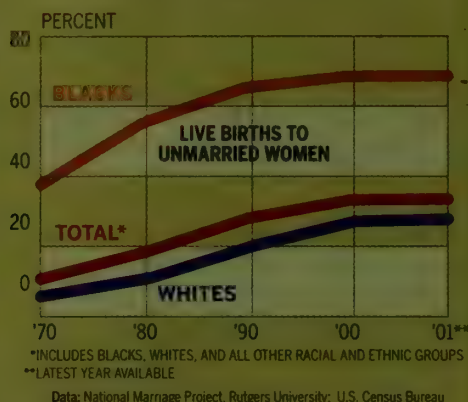
Men increasingly see marriage as optional...

HIGH SCHOOL SENIORS WHO SAID CHILD-REARING OUTSIDE OF MARRIAGE IS A WORTHWHILE LIFESTYLE



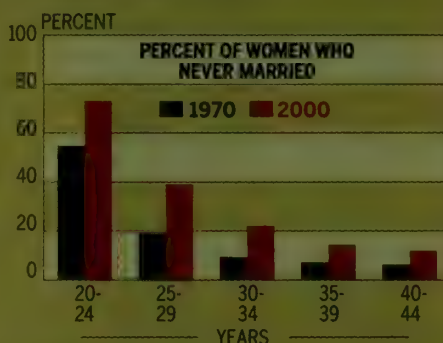
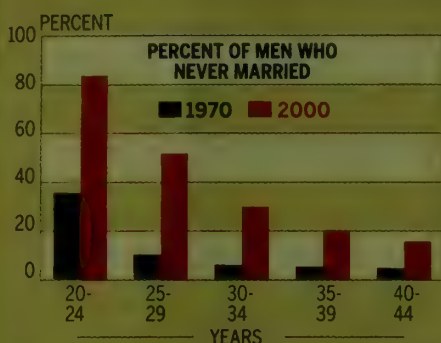
Data: National Marriage Project, Rutgers University; Survey Research Center, University of Michigan

...out-of-wedlock births are on the rise...



Data: National Marriage Project, Rutgers University; U.S. Census Bureau

...and more adults are forgoing marriage



Data: Pearson Education, U.S. Census Bureau

for spouses. Another would mandate that the federal government offer health benefits to domestic partners; in the past few years, Minneapolis, San Francisco, and Seattle, among other cities, have also passed laws obligating companies doing municipal business to do so.

The lower marriage rates, combined with declining fertility, also raise questions—ones Europe and Japan are already facing—about whether smaller future generations will be able to support the growing retirement and health needs of the huge numbers of older people. Can the country pump out enough educated workers to supply the labor force with the talent it needs to keep productivity strong? Will minority groups and immigrants, who tend to have higher fertility rates, gain more power? The answers to these questions will shape social policy and force corporations to rethink their human-capital strategies, product lineups, and marketing missions. Because unmarried America has such diverse constituencies—from urban swingers to straitlaced widows—it will also mean more micromarketing to cater to these finely tuned population segments.

Rumblings of a Backlash

THE TENSIONS BETWEEN TRADITIONAL families and the new households are already starting to spill out all over society—in offices, neighborhoods, and political campaigns. Pollsters Celinda Lake and Ed Goas say the marriage gap could become an issue in the 2004 Presidential campaign since George W.

Bush draws so much of his support from the wedded, who give him approval ratings 15 percentage points higher than the single or divorced. Meanwhile, the numbers Democratic-favoring singles continues to grow in number and power. There are already rumblings of a political backlash as non-traditional families balk at lopsided tax burdens. Dual-income, kid-free cohabitants, and elderly retirees on fixed incomes, for example, are joining forces to oppose school bond issues, a growing argument now that only 20% of the electorate has children. Charlotte Ness, a 55-year-old childless single, fumes about the way she pays the same school taxes as the married couples in her Vienna (Va.) neighborhood but will only get half the capital-gains break on the sale of her home. "It's nothing other than theft by a government of married people," she says.

Some singles are challenging zoning laws that limit the number of unrelated people who can live together, while others are forming homeowner associations to ban kids. Then there are those who are working to bar travel-industry practices that force them to pay 40% to 100% more for single-occupancy hotel rooms as well as auto and health-club rules that limit discounts to spouses. "You never used to have this," says David Popenoe, co-director of the National Marriage Project at Rutgers University. "Those without children and those who aren't coupled have begun to mobilize much more than they did in the past."

Also fueling the demographic change: More people are coming out of the closet and setting up same-sex households. And most everyone, on average, is living longer, which will make for an expanding population of widows as boomers age. Meanwhile, more seniors are divorcing so they can qualify for Medicaid, while others are living together instead of remarrying.

SINGLE

At 35, New York communication director Hillary Herskowitz says: "I want to have a family. I never ever thought I'd wind up here"





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avoid losing pension-survivor or health benefits. "Sometimes you have to break the rules to make a living," says 64-year-old Darlene Davis, who lives with her boyfriend of 19 years, Cary Cohen. Marrying Cohen would mean losing her deceased husband's health benefits, which she relies on as a heart-attack survivor with three stents. Last year, the state of Virginia refused to renew her day-care license because of old laws on the books that classify cohabitation as illegal. But after the American Civil Liberties Union took up the case, officials relented. "In the spiritual sense, we are husband and wife," she says. "But the law just doesn't see it that way."

Neither does the workplace, where singles get less and pay more. Married people often make more than unmarries, with married men earning an average 11% more than their never-married male colleagues, according to the Federal Reserve. The unmarried, most importantly those with kids, also suffer higher unemployment. And aside from subsidized health coverage for spouses, there are plenty of other inequities. Social Security is one of the biggest redistributions machines there is: Married and unmarried co-workers pay the same amount in employment taxes, but married people can leave their Social Security benefits to surviving spouses, while the unmarried can't leave them to surviving partners.



COHABITING

For 19 years, Cary Cohen has lived with Darlene Davis, 64. If they got married, she would lose her deceased husband's health benefits

can you compensate one employee more than the other?" Murphy was also stunned to learn that she had no legal recourse: Federal anti-discrimination laws protect just about every class—race, religion, gender, age—except the unmarried.

Although marriage and fertility rates are at their lowest point in history across the industrialized world, an estimated 85% of Americans will still marry at least once in their lives—even though that is a huge drop from the historic high of 95% in the 1950s. Though Rutgers' Popenoe believes that marriage rates will continue to slide, there are some countertrends that could tilt the statistics back toward a marriage majority. An unforeseen legalization of gay marriage or an even bigger surge in married immigrants—who are already propelling up population growth—could dampen the trend. Hispanics, the fastest-growing minority group, tend to have higher rates of marriage, given their religiously rooted family values. Some demographers point to a late-1990s leveling-off of divorce rates and the number

of kids living with single parents as evidence that the institution may be approaching a turnaround. But most chalk that development up to the booming economy and welfare reform. Nothing less than a massive return to traditional values, they argue, will reverse the trend.

Judging by the attitudes of young people, that seems unlikely. Fully 54% of female high school seniors say they believe that having a child outside of marriage is a worthwhile lifestyle, from 33% in 1980, according to the University of Michigan Survey Research Center. And 40% of female twentysomethings would consider having a baby on their own if they reached their mid-30s and hadn't found the right man to marry.

What was once a frowned-upon alternative has become mainstream. Since 1970, the ranks of the never-married and childless have surged astronomically, according to the Census Bureau. There is also a creeping disconnect between marriage and child-rearing, with an 850% increase since 1960 in the number of unmarried couples living with kids. As for children, 40% of them will live with their mom and her boyfriend before they turn 16, according to the National Institute of Child Health & Human Development.

Certainly, there are scores of reasons to encourage marriage

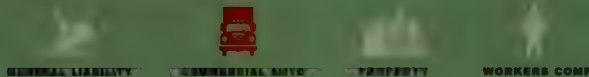
Pension Penalties

THAT'S ONE REASON WHY, given the gender pay gap, single working mothers often end up with far less in their old age than lifelong homemakers; one-earner married couples receive average benefit returns that are up to 85% higher than those of single males; and African Americans, who have low marriage and life-expectancy rates, sometimes end up subsidizing the retirement benefits of millionaire whites. In fact, one of every three black male youths will pay for retirement benefits they will never see.

Pensions also certainly come with big penalties for singles. If a married worker dies before starting to receive the benefits, a surviving spouse can inherit them. For singles, they go back into the pot. April Murphy, an unmarried 38-year-old who has worked as a flight attendant for American Airlines Inc. for 11 years, found this out when she tried to name her sister as her designate on her traditional pension. The company told her that was fine. But if Murphy dies even one day before her retirement, her sister won't see a penny. "When I'm pushing a beverage cart, the flight attendant on the other end is getting more just because she has a spouse or child or two," says Murphy. "How



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riage. Social research suggests that it is one of the republic's great stabilizers. Living with two happily married parents is the best shot a kid has for a successful launch in life. Marriage attaches fathers to children and protects adolescents from the scourges of addiction, suicide, teen pregnancy, and crime. Matrimony also offers families a layer of economic protection in an era when demands for individual competence and educational achievement have never been greater; when even members of the middle-class face slippery job security, diminishing benefits, and bidding wars for houses in the ever-dwindling number of good school districts.

Looser Ties

BUT JUST BECAUSE matrimony is good for society doesn't mean that outmoded social benefits are—especially when so many kids are not living in the kinds of traditional households that current social policies favor. As more and more companies begin to loosen the connection between benefits and marriage—and partners who act like they are married are treated as if they are—it's likely that there may be even higher rates of cohabitation and even lower rates of marriage, as has already happened in Europe. The difference, though, is that European countries have stronger social safety nets in the form of long, subsidized maternity leave policies; good part-time jobs for mothers; and tight-knit extended families, who help care for children born to single parents.

In America, the debate over the relative prominence of unmarrieds and marrieds is likely to grow more complex and caustic as the tipping point nears. Some say that the country is sliding down a slippery slope, gutting one of the last social safety nets that exists. Critics warn of an atomized society of subgroups, each vying for its selfish interests, with children the ultimate victims. But others say that given the demographic trends, what's needed isn't a nostalgia for the past but a rethinking of our notions of relationships, parenting, and family. No matter how the politics play out, the demographic convulsion is certain to cause a collective reexamination of what it means to be full-fledged members of society. No matter if you think that's for better or worse, husbands and wives no longer have a monopoly on that. ■

—With Jessi Hempel in New York

COMMENTARY

BY ALEXANDRA STARR

Washington's \$1 Billion Lecture to the Poor

Why a "pro-marriage" bill isn't likely to help much

THE DECLINE OF THE two-parent family has long prompted conservative hand-wringing. The Bush Administration, however, is on the case. As part of a welfare bill moving through Congress, the President seems poised to win \$1 billion over five years to promote marriage. The funds could be used for a national ad campaign championing the benefits of wedlock, for premarital counseling services, and for instruction in high schools.

It's certainly true that children do better when they're raised by married biological parents—provided the relationship is relatively friction-free. And there's ample evidence that teaching middle-class couples communication skills can be helpful in keeping fragile unions together. But the President's plan to spread the marriage gospel in poor communities is likely to do little to salvage the troubled institution.

The biggest problem with the scheme, which Congress is likely to approve now that a key Senate committee passed it in September, is that it turns a blind eye to the broader issues that plague many poor households. As Rachel Gragg, a social policy expert at the Center for Community Change, a liberal advocacy group, puts it: "It's hard to devote yourself to a relationship when you're worried about whether you can

buy food, pay the rent, and keep your kids safe."

A more effective approach would be to fund a variety of assistance programs that promote marriage in more indirect ways. For example, an initiative Minnesota tried a few years ago lifted marriage rates in impoverished communities by helping to improve the economic stability of families. Even though the Minnesota Family Investment Program made a big difference, it was expensive and wasn't renewed when the initial experiment came to end. How did the MFIP manage to lift marriage rates? The program allowed parents on welfare to continue to collect benefits even after they found jobs as

long as their earnings didn't exceed the poverty threshold (now \$14,500 for a family of three) by more than 40%. By allowing welfare checks to be combined with income from work, the MFIP helped to keep couples together and made marriage seem a more viable option.

While Bush's pro-marriage bill may be a heartfelt response to the decline of the traditional family, most of the money would probably wind up helping middle-class couples. Why? Similar experiments by several

states show that they're the ones who are easiest to sign up, while welfare moms are more difficult to reach. It would help children's well-being if more were raised within healthy marriage. But the Administration's plan may be more of an exercise in good intention than effective social policy. ■



Welfare moms need child care, not an ad campaign

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Red Flags Rising At the Merc

The Chicago exchange is rife with conflicts and "independent" directors who aren't.

WITH SO MUCH ongoing drama at the New York Stock Exchange, little attention has been paid to that other great anchor of the U.S. markets—the Chicago Mercantile Exchange. The Merc is a veritable island of corporate governance tranquility. The futures-trading bourse did some soul-searching before it became a public company last year, and found its corporate governance to be in fine shape. Still, the Merc's incoming chief executive, Craig S. Donohue, says the 105-year-old exchange—like its East Coast brethren—is about to undergo far-reaching changes. "There is no doubt that we are going to continue to evolve and change," says Donohue.

The Merc certainly will be changing—if not voluntarily, then with a push from the Commodity Futures Trading Commission, which is delving into market governance. And for good reason. The Merc board—including its compensation

committee—remains controlled by traders and floor brokers who are regulated by the exchange. Indeed, the Merc seems rife with the same conflicts of interest that tarnished the Big Board before CEO Richard A. Grasso self-destructed, including consulting deals for directors such as former Chairman Leo Melamed. Under the definition employed by the Merc, Melamed and brokers regulated by the exchange can become "independent directors"—an oddity that conjures up memories of the attempt to name former Citigroup Inc. Chairman Sanford I. Weill to a "public" position on the NYSE board.

A review of public documents shows that the Merc shares the NYSE's tin ear on governance issues. The Merc's 20-member board is dominated by people who are anything but independent. Most make their living in or around the Merc's trading pits. Only 4 of the 20 directors have no current ties to the Merc or its trading floor. Fifteen are longtime exchange members, many still working as traders or brokers.

The Merc has insisted that its gover-

nance policies are more than adequate and that all its directors are "independent" except for chief executive James McNulty, who will be succeeded by Donohue at yearend. With their diverse backgrounds, they offer "independent objective views," wrote board Chairman Terrence A. Duffy and former Chairman John F. Sandner, a paid adviser to the Merc board, in a letter posted on the exchange Web site. And though Donohue says the Merc expects to increase the number of board seats held by people with no ties to the Merc, he sees no problem with the current setup. Says Donohue: "Our board is absolutely and definitely independent from management. None of our so-called member-directors has a sufficient relationship with the institution to compromise their independence."

But such views are unlikely to satisfy regulators. Notes one top Securities & Exchange Commission official: "Mem-

The Merc's Brand of Governance

The Chicago Mercantile Exchange, a publicly traded company that says its board is dominated by independent directors, is beset by conflicts of interest:

INSIDER DOMINANCE Fifteen of the exchange's 20 directors are floor traders or do business at the exchange, but are defined as independent because they are not employed by the Merc

CONSULTING DEALS Two directors, both former Merc chairmen, are paid at least \$200,000 a year as board advisers

REGULATORY CONFLICTS Many directors trade regularly in the pits or run companies that do so, even though the board is in charge of regulatory apparatus



as have always been considered insid-
rather than public or independent
members." One potential sore spot is the
board's compensation committee. It
chaired by William R. Shepard,
founder and president of Shepard Inter-
national Inc., a futures brokerage. He did
return phone calls. The other mem-
bers are a floor broker, the head of a trad-
ing company, and former Agriculture
Secretary Daniel R. Glickman. Compen-
sation is a hot topic at the board, in light
of McNulty's lucrative pay package, de-
vised by a previous pay panel, in which he
received \$1.8 million, plus an option package
valued at over \$66 million.

IN HOT WATER

CRITICS, THE FACT that brokerage
firms such as Shepard are considered in-
dependent directors is absurd. "It raises a
lot of red flags," says Ann Yerger, deputy
director of the Council of Institutional In-

vestors. Also troubling to
critics is that ostensibly in-
dependent directors seem
burdened with glaring con-
flicts of interest. Former
Chairman Melamed is paid
\$200,000, plus \$150,000
for expenses, as a "senior
policy adviser" to the ex-
change board. Likewise,
board member Sandner is a
"special policy adviser," for
which he gets \$200,000 a
year, plus meeting fees.

Both men play big roles in governance
at the exchange. Sandner chairs the
Merc's governance committee, which
also includes Melamed. The ex-Merc
chairman, a renowned figure in Chicago's
market, is in some hot water because of
his conflicting roles. The Merc is being
sued by a former executive, Lewis C. Ting,
who says his governance recommenda-

tions were disregarded. In the suit, Ting
says he was wrongly fired in part because
he complained to Merc executives that
board members routinely "engage in
practices designed to compensate them-
selves and their friends at the expense" of
the Merc. The suit cites Melamed's ex-
pense allowance as an example. Ting
blames Melamed for his firing, saying
Melamed resisted changes in corporate
governance that were championed by
Ting. The Merc declines comment on the
suit as does Melamed, who says he trades
only for his own account.

DRAMATIC CHANGE

SUCH COZY PRACTICES MAY be in jeop-
ardy. The CFTC, which oversees the Merc
and other futures exchanges, has put all
such self-regulatory organizations
(SROs) under a microscope. Asked about
the apparent conflicts at the Merc, a
spokesman says CFTC Chairman James
E. Newsome directed his staff, in May, to
review "the roles, responsibilities, and
capabilities of SROs." He added that SRO
governance is one element of the review,
which should be finished by yearend.

Even without pressure from the
CFTC, the Merc's governance practices
are ripe for scrutiny. "It's not a private
club anymore," says Nell Minow, editor
of The Corporate Library LLC, a research
firm that tracks governance issues. She
argues that a board that appears to be
run by and for traders isn't serving the
public. Donohue says changes are com-
ing. He notes that the Merc board has al-
ready changed dramatically, that it is
half its pre-IPO size, and that 13 direc-

torships could be filled by
completely unaffiliated
folks over time. Adds
Glickman: "The board is
going to have to bring in
more outside directors as
time goes on."

Melamed insists that he
and his fellow directors are
already models of propri-
ety. "We have been jealously
independent," Melamed
says. His job at the Merc,
he says, is as a "thought

leader." There's no denying that
Melamed is one of the smartest men in
the world of finance. But as another
bright man by the name of Dick Grasso
can attest, it takes more than brainpow-
er to satisfy the gods of corporate gov-
ernance nowadays. ■

—By Joseph Weber in Chicago, with
Gary Weiss in New York and Amy Borrus
in Washington

CRIME SCENE

Ammon was found in his Hamptons mansion in October, 2001



A Murder Mystery, A Money Mess

Behind the nasty fight over what's left of Ted Ammon's millions. **BY MARCIA VICKERS**

ADASHING, HIGHLY SUCCESSFUL Wall Street financier is murdered just days before he is due to complete an acrimonious divorce from his wife. The wife inherits almost everything and soon marries her boyfriend, an electrician who has served several jail terms and has stated publicly that he is a target of the murder investigation. Less than two years later, the wife dies of cancer—and now a battle is brewing over her will.

As the saying goes, you just can't make this stuff up.

Almost two years after the murder of R. Theodore Ammon, the crime has yet to be solved. It is an incredibly sordid, complex saga. But just as murky are the financial questions left in the wake of the killing of Ammon, a 52-year-old former Kohlberg Kravis Roberts & Co. partner and chairman of Jazz at Lincoln Center. How, for example, did Ammon's assets—worth an

estimated \$200 million at the peak of his career—dwindle to \$34 million by the time his estranged wife, Generosa Ammon Pelosi died? What has happened to the Ammon Foundation, the charity that has been virtually inactive since its founder's death? And what about the lawyers who will now exercise almost unfettered control over both the foundation and the trusts established for Ammon's 13-year-old twins?

In an exhaustive review, *BusinessWeek* has managed to account for Ammon's missing millions, most of which disappeared in the tech stock collapse of 2000. But the investigation amplifies questions raised by Ammon's friends over whether the remaining millions will be used as he intended. Under the wills

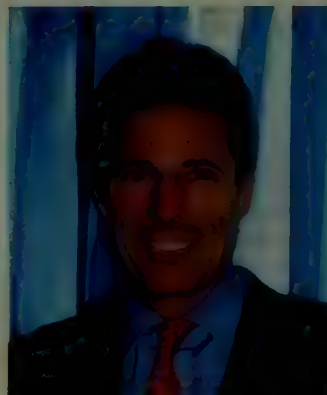
of Ammon and his wife, the foundation due to receive about \$40 million now that Generosa has died.

Some friends of Ammon are surprised at the central role his wife created for her two lawyers, Michael G. Dowd and Gerard J. Sweeney. Both Dowd and Sweeney began representing her just after the murder. Despite the brevity of this relationship, Generosa's deathbed will names the lawyers executors of her estate and trustees for the Ammon children, a son and daughter adopted from the Ukraine. The will also names Dowd and Sweeney sole trustees of the Ammon Foundation.

These multiple roles create the potential for a rich stream of fees for the two lawyers. Usually, a will names one executor who collects a standard commission about \$1 million on an estate the size of Generosa's—estates experts say. Yet both Dowd and Sweeney are named executor, and Dowd confirms that each will collect

a one-time commission as much as \$1 million. That arrangement is legal but it has raised eyebrows. "It seems a bit unusual," says R. Edwin Townsend, a Manhattan estate attorney.

As trustees for the \$100 million Generosa left the twins, the lawyers also legally collect 1% of the estate's income each year, plus 1% of the principal every time a distribution is made to the twins. Those sizable fees will last until the children



GOLDEN BOY Ammon was something "out of a Fitzgerald novel," says a pal

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50 years old—a provision Generosa insisted upon, according to a source familiar with the will. Says Dowd: “I would guess we would both be collecting commissions [as executors]. I don’t know if we are both collecting fees as trustees.” Sweeney would not comment on the record. Dowd and Sweeney could also earn annual fees as trustees of the Ammon Foundation.

Daniel Pelosi, the electrician whom Generosa married after Ammon’s death, is challenging his estranged wife’s will. He received \$2 million under a post-nuptial agreement but was not named in the will. His estates attorney, James Spiess, claims Dowd and Sweeney “exerted undue influence on [Generosa] when she was on her deathbed” and that her signature on the will is illegible. Dowd vehemently denies this and says cancer had crippled his client’s right hand.

Sweeney and Dowd are somewhat controversial figures themselves. Dowd, a Manhattan attorney who has represented several women accused of murdering their husbands, had his law license suspended for four years in 1990 after he confessed to doling out kickbacks to Queens (N.Y.) politicians in a scheme involving the Parking Violations Bureau.

The scandal implicated Queens Borough President Donald Manes, who subsequently committed suicide.

Sweeney has been a legal bigwig for the Queens Democratic Party since the 1980s. For years he has been allowed, by court mandate, to collect fees from the estates of all Queens County residents who die without a will or survivors. While legal, it’s a job for which he has been widely criticized. “Sweeney makes about a million a year from doing this—despite being in private practice as well,” says a Queens lawyer who asked not to be identified.

POWER CROWD

THE TED AMMON MURDER could be this century’s Stanford White tale. On Oct. 22, 2001, the handsome, athletic Ammon was found naked and bludgeoned to death in his \$10 million ivy-covered East Hampton manse. Among the 1,000 or so mourners at his funeral were such powerful Wall

The laptop used to gain entry the night of the murder “was burned in a fire,” says Generosa’s lawyer

Streeters as KKR Chairman Henry R. Kravis; Apollo Management’s Leon Black; investor and former Deputy Treasury Secretary Roger Altman; and Quadrangle Group head Steve Rattner. “Ted, even by Wall Street standards, was an exceedingly skillful and talented businessman,” says Altman. “But more than that, he was a golden boy, the most attractive person you ever met—out of a Fitzgerald novel.”

Although never a legend, Ammon was a prosperous and energetic presence on Wall Street in the heady ’80s and ’90s. He joined KKR in 1983 and worked on the firm’s signature deal, the 1988 RJR Nabisco takeover. In 1990, he testified against junk-bond king Michael R. Milken on KKR’s behalf.

Ammon was only the second partner ever to depart KKR voluntarily, cashing out in 1992 at age 42 for an estimated \$50 million. Shortly after, he founded Flower Press, now called Vertis Inc., a highly profitable company that print

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newspaper circulars. He started a private-equity firm, Chancery Lane Capital, to fund other ventures.

Ammon also started giving money away. In 1988, he created the Ammon Foundation, naming Generosa as co-trustee. He donated more than \$1 million to Jazz at Lincoln Center and almost \$15 million for scholarships at his alma mater Bucknell University, the school's largest gift ever. "Ted didn't want his name on anything," says Ammon. "He was incredibly selfless," says Bucknell President Stephen H. Rogers.

Some of Ammon's friends say they were perplexed as to why he was married to someone like Generosa, who could be difficult even in the best of times," says Ammon. They married in 1986. In later years, Generosa became more and more demanding. Convinced he was having af-

Where Did the Money Go?

Wall Streeter Ted Ammon was once worth as much as \$200 million before his murder. But after his estranged wife died recently, her estate was estimated to be worth only \$34 million. Here's what happened:

Numbers are estimates

\$100 Million

Was lost in the NASDAQ crash

\$32 Million

Went to repay J.P. Morgan Chase loans

\$9 Million

Went to fulfill charitable pledges and cover estate fees

\$25 Million

Went into a trust for the Ammon Foundation

\$34 Million*

Went to estranged wife, Generosa

* Does not account for money Generosa may have raised or spent after Ammon's death

Data: BusinessWeek, J.P. Morgan Chase

separated, she had him followed by a private investigator, friends say, and began dictating his time with the children.

Some months before Ammon's untimely death, Generosa had taken up with Pelosi, an electrical contractor she had hired to supervise the renovation of an \$8 million Upper East Side townhouse. More "dems and dose" than debonair, Pelosi had been arrested numerous times over the years on felony and assault charges and served three jail terms for drunk driving. Pelosi had installed the video-surveillance system in the Ammons' East Hampton house—equipment that

was shut off the day of the murder. Pelosi's criminal defense lawyer, former John Gotti defender Gerald L. Shargel, would not comment on the murder investigation.

After the murder, Generosa and Pelosi wed and immediately moved, with the

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twins, to Surrey. The family was soon forced to return to the U.S. so Pelosi could serve jail time on Long Island for drunk driving. In the spring of 2002, Generosa learned she had cancer. She died on Aug. 22, 2003. Days later, Pelosi was pictured in the *New York Post* with Generosa next to him at the bar at the Stanhope Hotel—that is, her ashes in a box. He had ordered their favorite drinks, lit a cigarette in her honor, and summoned a photographer. Generosa and Pelosi had been living separately for months prior to her death, say her lawyers.

MONEY TRAIL

THERE'S NO QUESTION that Ammon's estimated \$200 million fortune dwindled considerably—perhaps by half—after the NASDAQ crash in March, 2000. Ammon invested in numerous Internet startups in the late '90s. For instance, he held major stakes in Cais Internet Inc., which went bankrupt in October 2001, and 24/7 Real Media Inc., an Internet advertising company.

Ammon's estate, according to an inventory filed with the New York State Surrogates Court, was valued at \$97 million gross shortly after his death. The document, compiled by his executors, J.P. Morgan Chase & Co., details Ammon's assets down to the last penny. He owned a collection of wines valued at around \$154,000, a membership in the Hamptons' Atlantic Golf Club worth \$175,000, and an Aston Martin, a Porsche Carrera, and a BMW.

But Ammon's estate had to repay \$31.5 million to J.P. Morgan, mostly for a loan that funded his private-equity business. He had charitable pledges and estates fees totaling some \$9 million, according to J.P. Morgan sources. Half of his remaining fortune passed to the Ammon Foundation. Although Ammon held \$40 million in life insurance policies, none of that money passed to Generosa. More than half belongs to the children and the rest to Chancery Lane Capital.

Generosa was convinced Ammon had been hiding millions from her because of the divorce, say friends. And J.P. Morgan Chase initially took the unusual step of challenging her status as co-executor of the estate after the murder. J.P. Morgan eventually gave in, deciding "it was ultimately up to the courts to decide whether [Generosa] was fit to administer the estate," says a source within the bank.

The Ammon Foundation appears to have been virtually dormant since Ted Ammon's death



Generosa sold off at least \$40 million in real estate holdings in less than a year—some at a loss. She unloaded Ammon's \$26 million interest in printing company Moore Corp. (now Moore Wallace Inc.), according to Securities & Exchange Commission documents, and auctioned artwork—including an \$85,000 Alexander Calder sculpture—for a total of at least \$2 million.

An orphan who grew up with relatives and in foster homes, Generosa had no family to turn to when she learned she had cancer. So she appointed her housekeeper as the twins' guardian—a move that has been challenged by Ammon's sister. The court recently appointed lawyers to look out for the children's share of the estate.

The twins' lawyers would not comment on the record. But estates experts say their mother's will—signed on July 22, a month before her death—is ripe for challenge. Says William P. LaPiana, a wills, trusts, and estates professor at New York Law School: "This is shaping up to be a classic will contest. The children's lawyers could ar-

POST-POST-NUP
Pelosi accepted \$2 million but is now challenging Generosa's will

gue, for instance, that a bank would be more objective trustee" than Dowd and Sweeney.

Pelosi's lawyers are also poring over the will. If it is invalidated, her prior will would be enforced—and that left almost her entire estate to Pelosi. Meanwhile, Pelosi was recently charged with second-degree grand larceny for stealing electricity by rewiring his Long Island home. Sharp says Pelosi has pleaded not guilty.

UNFULFILLED PLEDGE

AFTER THE WORLD TRADE Center disaster and just before his death, Ammon made a pledge to the nascent Twin Towers "Tribute in Light" project. A source close to Ammon doubts the pledge was fulfilled. A project spokesman was unable to verify the gift by press time. "Generosa seemed almost averse to giving money away," says a family friend.

The Ammon Foundation appears to have been dormant since the murder. It has not filed any Form 990s, the tax return nonprofits must complete for the Internal Revenue Service, according to the Foundation Center, a private foundation researcher. In the last return available, for the year ended on Nov. 30, 2000, the foundation received about \$1.7 million in contributions from Ammon and gave out \$1.35 million, primarily to Jazz at Lincoln Center, leaving it with \$450,000 in assets.

The foundation is now set to receive about \$15 million from Generosa's estate and \$25 million from a trust, established by Ammon, upon Generosa's death. A source close to the case says Dowd and Sweeney plan to preserve the foundation's assets as much as possible until the children take over as trustees at age 21. "It's too early to talk about plans for the foundation," says Dowd.

Dowd has his hands full. He was recently forced to testify in front of a Long Island grand jury about the laptop computer that was used to gain access to the security system at the Hamptons hotel the weekend of Ammon's murder. Dowd admits the laptop ended up in his firm's possession after the murder but says it "was burned in a fire."

Ammon's friends are concerned about the fight over his estate. "You hate to see so much of what Ted worked for being tangled up with these lawyers and potentially even go to a murder suspect," says a friend. "It's tragic."

If Ted Ammon were alive, he would likely be using much of his fortune to better the world, say friends. These days, money doesn't seem to be doing much good at all. ■

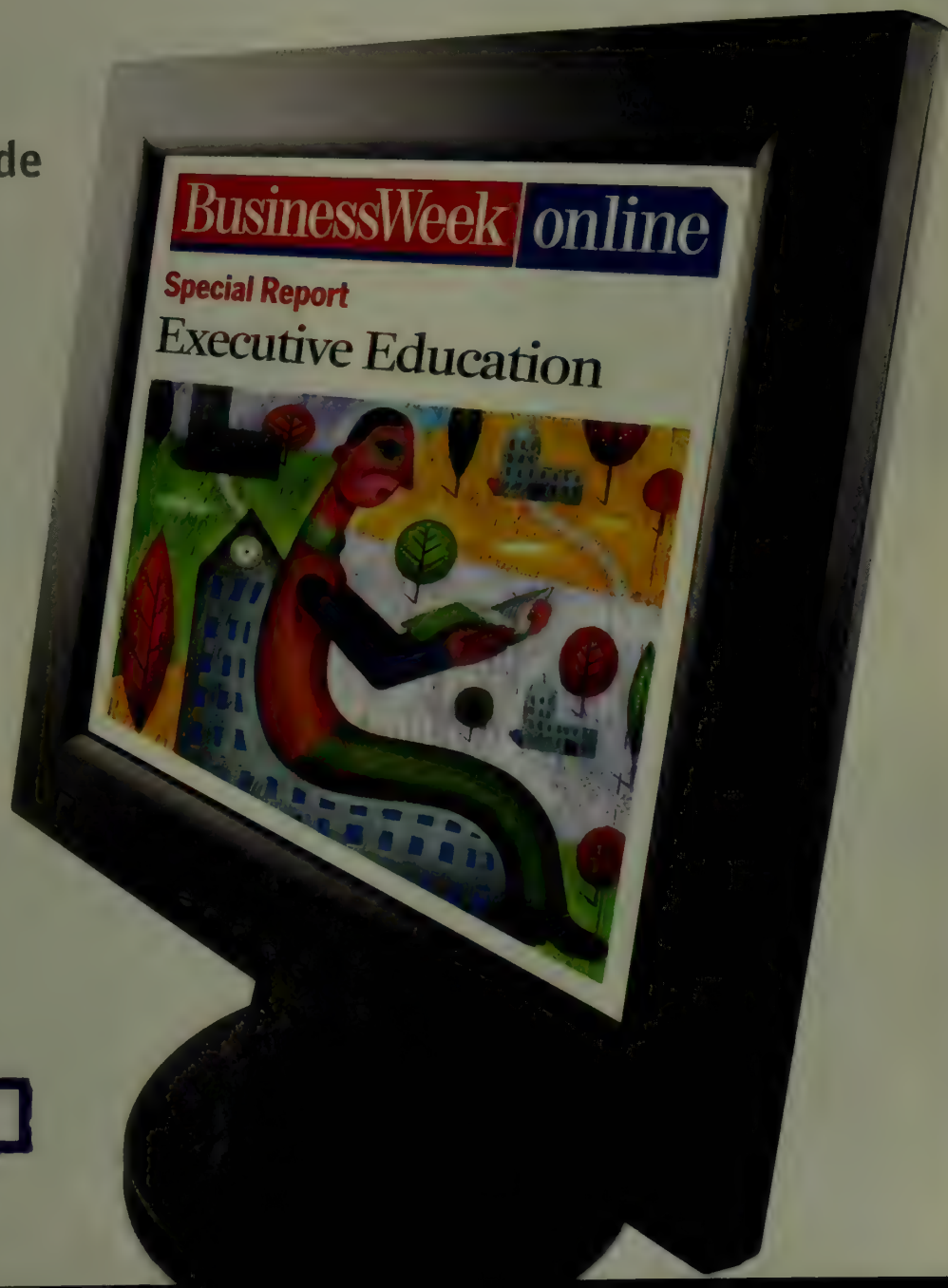
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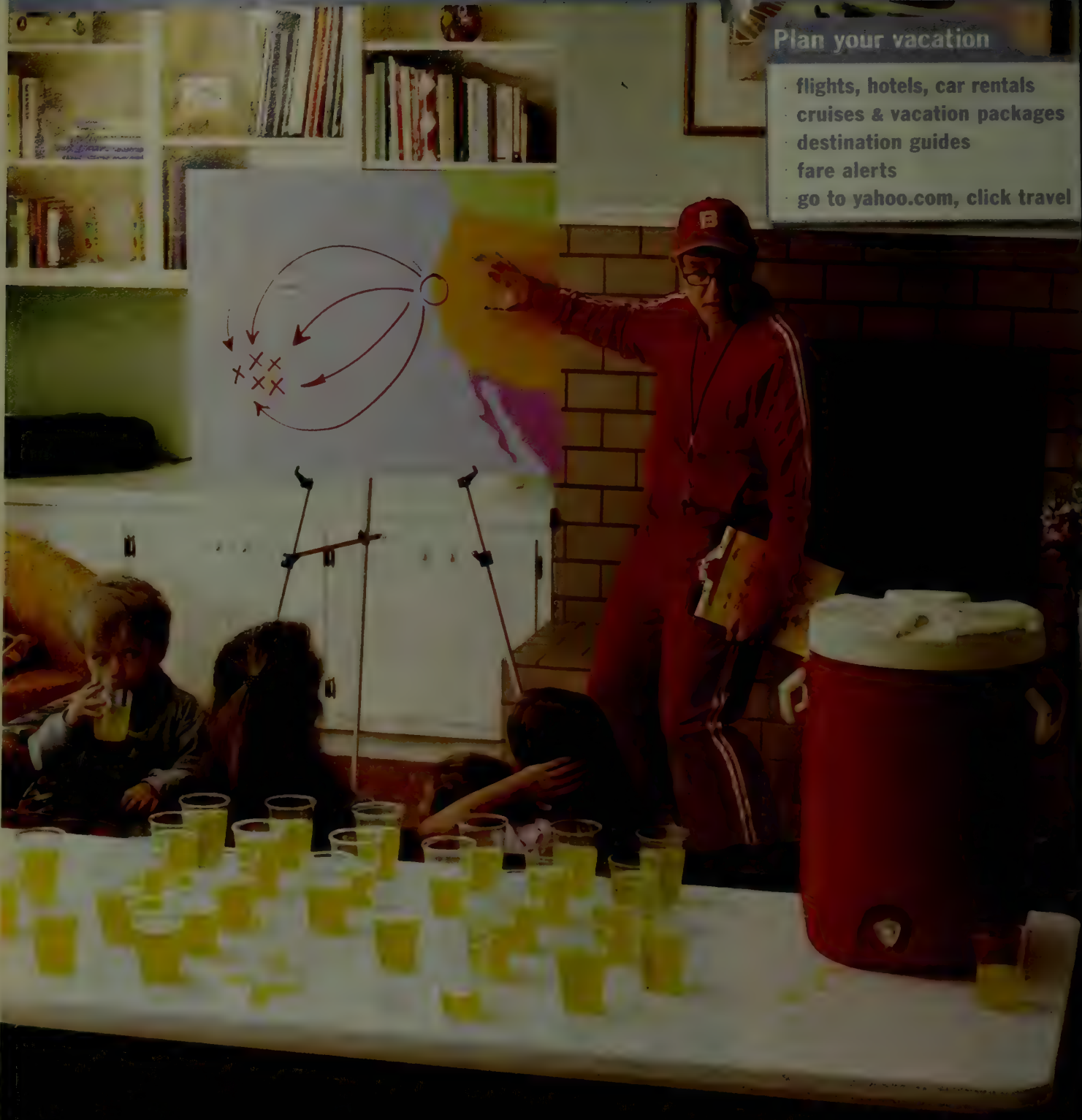
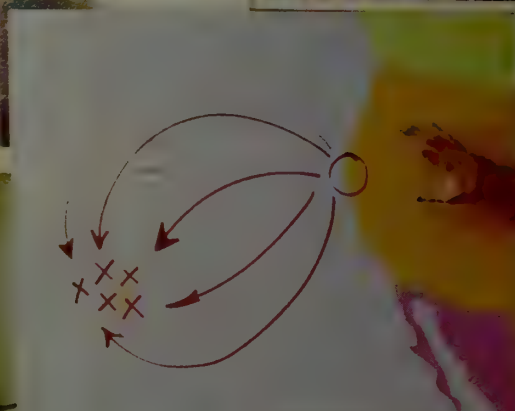
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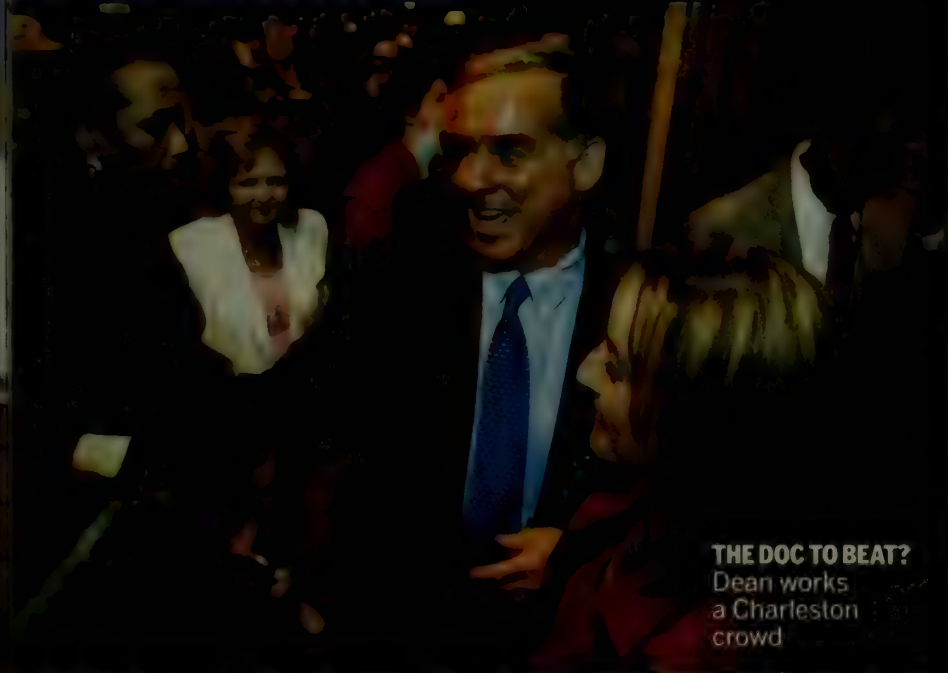
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South Carolina shakeout

For Democratic Presidential contenders,
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If Democrats are "running scared" in conservative South Carolina, as retiring Senator Ernest F. "Fritz" Hollings declared this summer, you wouldn't know it from the number of Presidential candidates popping up here.

Senator John F. Kerry announced his candidacy in Charleston. Senator John Edwards dropped in just hours after he publicly threw his hat into the ring. For General Wesley K. Clark made the state his first stop, the famed military academy in West Point, the second stop of his Presidential tour. And Al Sharpton has been so often that one minister chuckled that the preacher from New York seemed to open a church.

Why are all these candidates wooing voters in one of the most Republican-leaning electoral states in the country? The answer is: They have to. Timing and the unusual cross-section of voters make South Carolina one of the hottest contests in the Democratic political calendar. Primary voters go to the polls on Feb. 3, just the bellwether showdowns in Iowa

and New Hampshire. That means candidates who come up short in those two early races could shore up their standing with a comeback in the Palmetto State—and try to stop a potential breakout by former Vermont Governor Howard Dean.

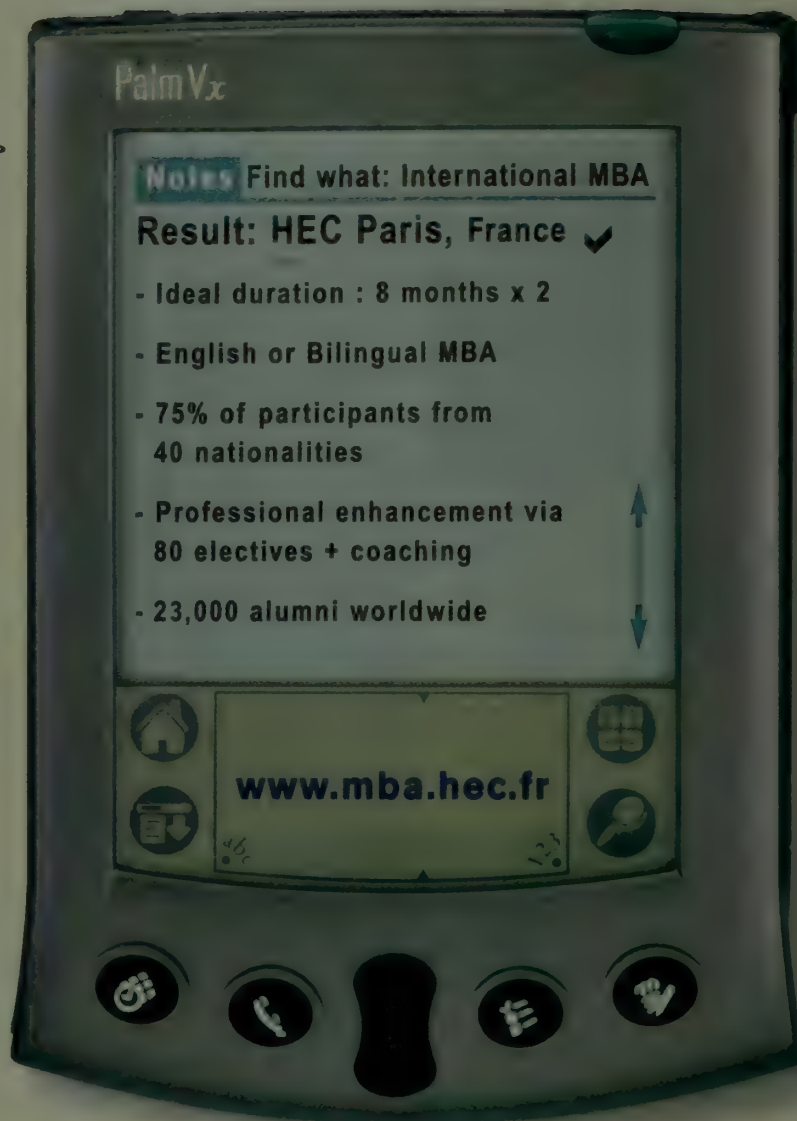
THE JOBS FACTOR

SIX OTHER STATES ARE voting on Feb. 3—Arizona, Delaware, Missouri, New Mexico, North Dakota, and Oklahoma. But South Carolina's voter demographic has attracted more attention. It is the first contest where African Americans—a key element of the Democratic base—will make up a sizable chunk of the electorate. At the same time, the primary is open to both Republicans and Democrats, so moderate-to-conservative whites will be represented as well. That could be crucial if the many military retirees and other veterans in the state turn out for Clark, the former four-star general.

And there is a third component that makes the state a litmus test: South Carolina has been slammed by the jobless recovery, with some 46,000 manufacturing

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THE PRIMARY TO WATCH

The top reasons that South Carolina is a litmus test for many Democrats

1 TIMING The state's Feb. 3 primary comes right after Iowa and New Hampshire. It's an opportunity for candidates who didn't do well in the early contests to stage a comeback.

2 DEMOGRAPHICS It's a diverse mix of voters, with a high percentage of African American voters and moderate-to-conservative white particularly military veterans.

3 ECONOMICS The state is hemorrhaging manufacturing and textile jobs, a microcosm of national trends.

jobs disappearing since George W. —who broke the Republican insurgency of Senator John McCain here in 2004—became President.

Surveying this unusual mix of ideology and demographics, most top Democratic hopefuls see a way to win the state. For some, a win will be essential if they are to remain viable. "Every campaign is in a position where they've either gotta win or they have to work really hard because they might gotta win," says Dean's campaign manager Joe Trippi.

That's particularly true for Edwards, the front-runner in the state, with strong support, according to a Sept. 2 American Research Group poll. The freshman senator—who likes to reassure South Carolinians he was born here—has been running TV spots almost daily but has not yet won the race. Nearly half of voters say they're undecided.

That could create an opening for Clinton. His Arkansas roots and military record could be a powerful draw for one of the 450,000 veterans and active-duty personnel in South Carolina. Kennedy is banking that his war record can appeal

em, too. And if Kerry loses New Hampshire to Dean, a strong showing in Dixie might be imperative.

POPULIST CHORD

R SHARPTON, a long-shot candidate at it, South Carolina's large turnout by African Americans—who account for perhaps half of primary voters—gives him his best opportunity to amass delegate support and clout at next July's Democratic convention. Former House Minority Leader Dick Gephardt thinks his economic populism and protectionist rhetoric will strike a chord with laid-off textile workers.

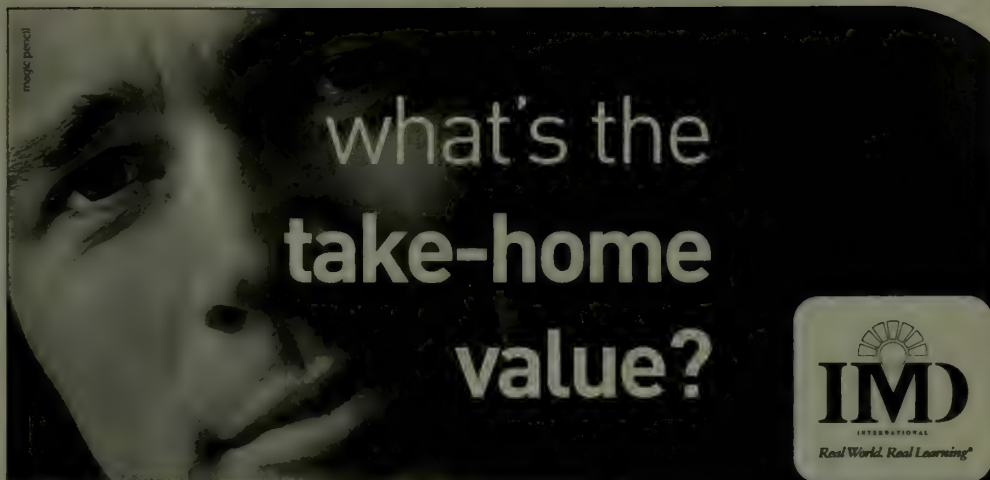
And Senator Joe Lieberman is hoping a centrist message will play well with white moderates. He also will try to exploit his appeal to blacks who still regard the Florida recount of 2000 as a willful disenfranchisement of their community and to churchgoing African Americans who appreciate his closely held religious beliefs. Playing the religious card does invite awkward moments, though. While he is attending Sunday services at the Morris Brown African Methodist Episcopal Church in Charleston last May, Lieberman, an Orthodox Jew, was asked heatedly by the leader of the gospel choir if he loved Jesus. The Senator just sat swaying to the music.

Dean appeared at the same church on Feb. 3 as part of a national "Generation Man" tour. The plain-talking pol raised eyebrows when he said in February that he would campaign among Confederate-sympathizing, pickup-driving Southerners because their dire economic conditions made them natural targets for the Democratic message. In Charleston and at the church, he delivered a toned-down version of that line. "South Carolina has voted Republican for 30 years," he shouted. "Tell me what you have to show for it."

Even some of Dean's ardent supporters are skeptical about how that would fly with most South Carolinians. "I don't know if they'll take too kindly to it," chorused Charlie Gaddy of Rock Hill, who with his wife drove three hours to see Dean. "The economy is so bad that maybe people will at least listen."

True, says Emory University political scientist Merle Black, they may listen, but South Carolina voters are unlikely to flock to Dean. "If [he] wins Iowa and New Hampshire, I think South Carolina could open a place for another candidate to emerge," says Black. Naturally, almost all of Dean's rivals are spinning fantasies about who that person might be.

By Alexandra Starr in Charleston, S.C.



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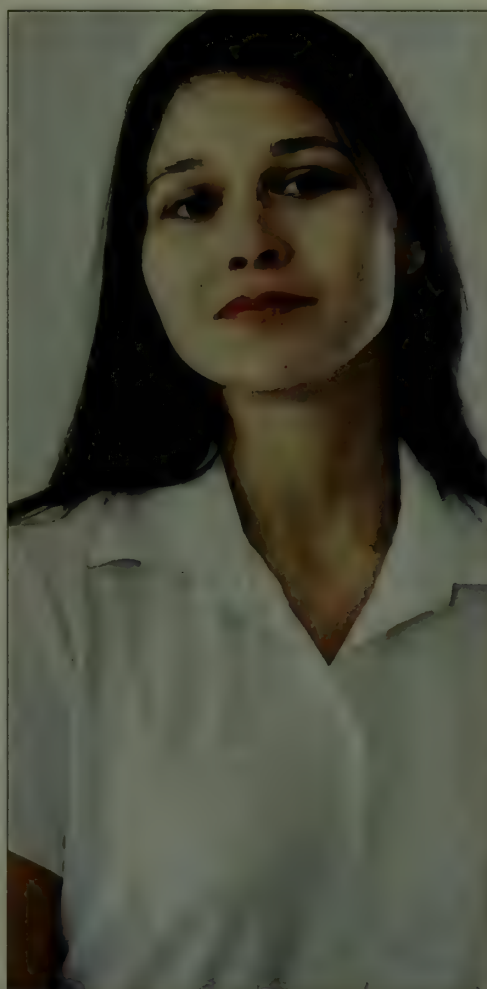
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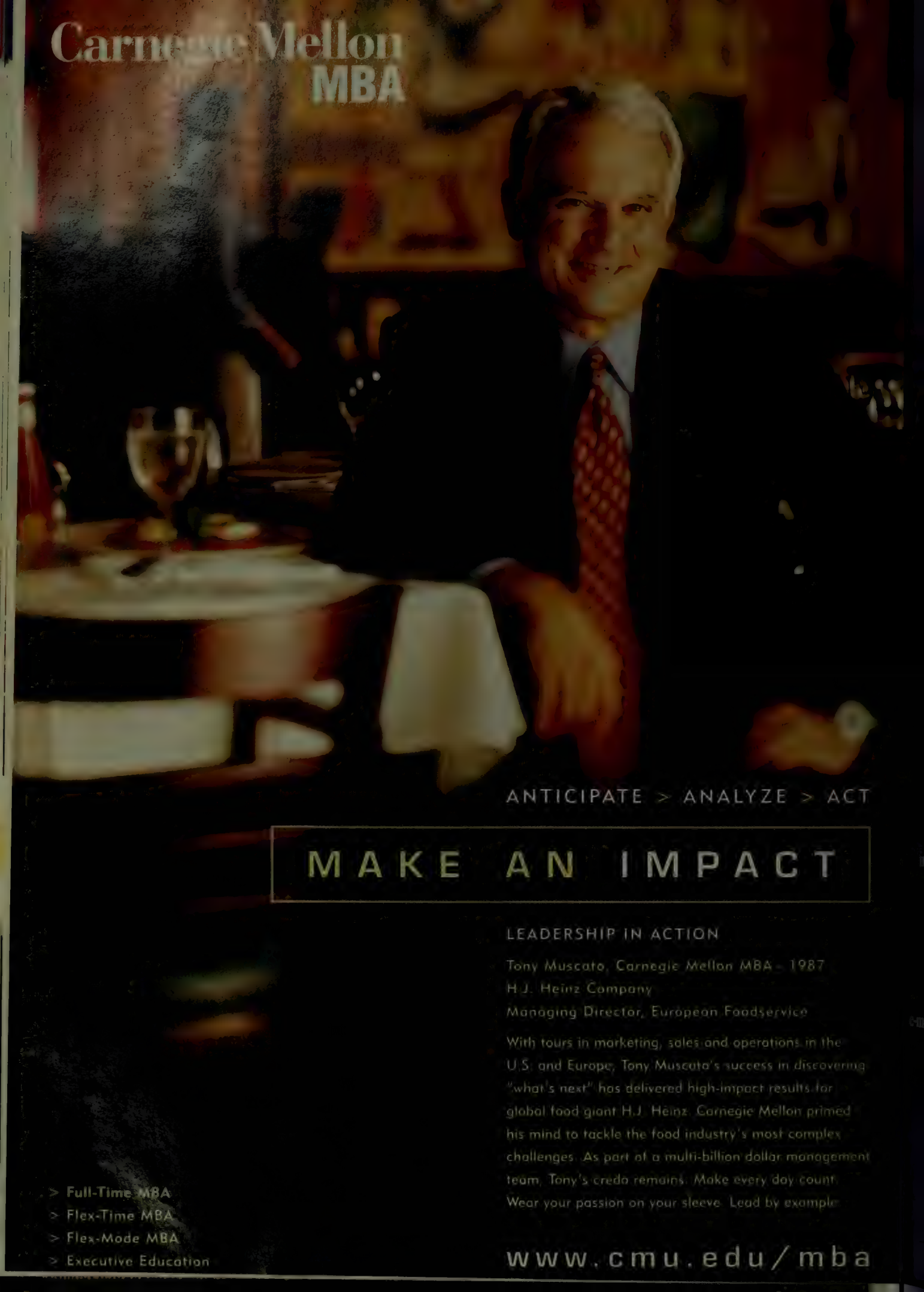
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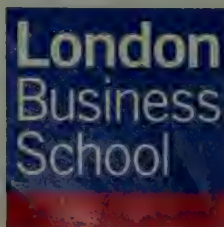
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BW10/10/03

Super-Radar, Done Dirt Cheap

A radar system that uses ubiquitous cell-phone signals is on its way

ANY TECHNOLOGY CAN be a two-edged sword. Cell phones are a good example. They're clearly a great convenience, even a life-saving tool during natural disasters and medical emergencies. And they could save many more lives under the Federal Communications Commission's proposed 911 mandate, which requires that cell phones relay precise locations to 911 operators.

For some people are afraid that their cell phone will give away where they are, that makes it possible to create a "road map" of a person's movements. So imagine the outcry when privacy worriers learn that cell-phone systems can be used to locate and track a car, boat, or plane—even if no one inside is carrying a cell phone. But outcry or not, the technology seems certain to be deployed, given its use in civilian and military applications.

The technology is called "cellular radar," from "cellular" plus "radar." Under development since 1997 at Roke Manor Research Ltd. in Romsey, England, it differs from conventional radar in several key aspects. When radar tracks objects for air traffic control or maps the surface of Mars from a space probe—the same set of equipment sends out radio signals and picks up the returning echoes. So computers can easily

calculate an object's distance and relative size based on how long it takes the returning signals to bounce back and how strong they are.

In contrast, Celldar takes a so-called passive approach: It watches and interprets how signals from cell-phone base stations interact with objects such as cars, trucks or planes. The hardware required for this is much simpler than existing

radar systems. A Celldar prototype built in 1999 consisted of a PC and the insides of two cell phones, and cost just \$3,000, says Peter Lloyd, head of Roke Manor's Celldar program. The flip side is, the signal-processing software is complex: It must allow for the varying travel times for signals between two or more cellular base stations and a Celldar receiver, as well as the times from the different base stations to the target. Lloyd says Roke's clever program is based on "\$10 million worth of expertise in writing software" for cellular systems and military radars. One big plus to the military: passive radar systems are invisible to anti-radar weapons because they don't have their own transmitters.

Celldar's implications are exciting—but also troubling to some. Even though the technology can't be used to identify cell-phone users, since it "sees" only radio waves echoing off hard surfaces, it and similar approaches are evolving quickly. In addition to Celldar, which is sopping up \$1.5 million a year for development, a dozen other passive-radar projects are under way in the U.S., Europe, and Asia. As the technology bears fruit, it should give the world's police and homeland security

Turning Cell Signals Into Radar

Britain's Roke Manor Research is developing a PC-based radar system that might cost less than \$3,000. Here's how "Celldar" works:

The world is now enveloped in a "soup" of radio signals from cell-phone transmission towers (1). The signals are continually bouncing (2) off cars, planes, boats, and other objects, just like radar. By tuning antennas to detect two or more of these echoes from a car, software on a laptop (3) can plot the car's location.

agencies new tools for monitoring shipments of illegal weapons and drug smuggling operations. Highway officials could gain a detailed window on traffic flows, helping them to minimize congestion. But because passive-radar systems could be cheap enough for hobbyists to buy—or cobble together themselves—the technology could also become the next fad among people who own police-radio scanners or who enjoy snooping on their neighbors' comings and goings.

This month marks something of a passive-radar milestone. In late October, Roke will show off the latest Celldar system to officials of Britain's Defense Ministry at an army exercise on the Salisbury Plain. During the field maneuvers, Celldar will detect the movement of ground vehicles and determine whether cell-phone signals are bouncing off a tank, truck, or armored personnel carrier.

Also in late October, radar researchers from around the world will gather in Seattle to discuss recent advances, including passive systems that use FM radio or TV broadcasts instead of cell-phone signals. The invitation-only meeting will be hosted by John D. Sahr, a University of Washington electrical engineer. Since 1997 he has operated a passive-radar system unshrouded by military secrecy. It harnesses an FM station's signals to study particles in the ionosphere—the top layer of the atmosphere, over 300 miles up. Sahr decided to go with passive radar, he says, “because it's incredibly cheap”—\$20,000 vs. \$25 million for a comparable active system. “You could probably do an amateur system for under \$5,000,” Sahr adds. A system for small airports might cost as little as \$15,000. That's important because of the 5,280 public airports in the U.S., only about 300 currently have radar.

STRONG SIGNALS

Lockheed-Martin Corp. is perhaps the best-known passive-radar champion, but others include Avtec Systems, Dynetics, and ONERA, the French counterpart of NASA. Lockheed-Martin's system is dubbed Silent Sentry. Last fall, in a demo for the U.S. Air Force, a third-generation Silent Sentry radar tracked all the air traffic over Washington, D.C., by picking up FM and TV echoes. Because FM and TV transmissions are more powerful than their cell-phone cousins, Silent Sentry can detect planes as far away as 135 miles,

roughly 10 times the reach of an individual cell-phone tower.

However, because cell-phone towers are scattered far and wide in many countries, an airborne Celldar system “could covertly monitor a whole country” by flying along its borders, says Lloyd. At the Seattle meeting, Roke Manor and British aerospace giant BAE Systems, which signed on as a Celldar partner in July, 2002, will reveal details on their progress toward systems for small robot spy planes as well as Airborne Warning & Control Systems (AWACS). With BAE on board, Lloyd declares, “we could field an AWACS model in two years.”

That claim prompts some skeptical head-scratching by Benjamin J. Slocumb, a senior research engineer at Numerica Corp., a small



How To Use "Passive Radar"

The technology, which doesn't require a radio transmitter, has myriad applications:

AIR DEFENSE

If there are gaps in existing radar systems, passive radar could plug them

INTELLIGENCE GATHERING

Spy planes flying outside an adversary's border could covertly detect movements of its military air, ground, and sea forces

BATTLEFIELD RECONNAISSANCE

In a conflict, field commanders could spot tanks and other vehicles hidden under trees

COASTAL DEFENSE

Ships, small boats, and perhaps submarine periscopes could be tracked

TRAFFIC MONITORING

Highway authorities could analyze traffic flow

Fort Collins (Colo.) defense contractor that develops advanced target-tracking algorithms. A receiving antenna that's moving, he says, “injects a whole bunch of difficult problems” in collecting and processing cell-phone echos. But Roke's Lloyd stands firm: “We'll show results in Seattle that are seven times better than [past studies] have said is possible.”

Despite Celldar's military potential, Lloyd predicts the first applications will come in the civilian sector. He says transportation officials are eager to use Celldar

to monitor road traffic because it would avoid the expense of installing either sensors in roads or TV cameras overhead. And police cars equipped with Celldar could follow a car driven by a suspected crook or terrorist from a safe distance without danger of being seen.

TRACKING MADE CHEAP

Celldar might also provide an alternative to the global positioning satellite (GPS) systems now being explored by insurance companies and governments for monitoring vehicles. Their goal is to set premiums individually, based on how much and how fast each car or truck is driven—or to charge a road-use toll determined by the distance a vehicle travels, over which type of roads, and at what times of day. In Ireland, AXA Insurance is testing a GPS system called Traksure. It continuously checks a car's speed and location, then compares

that data with the local speed limits obtained from digital maps. But Celldar might do the job more cheaply.

And it might support schemes in Oregon and other states regarding “pay-for-use” road taxes. Many transportation experts assert that tracking actual driving distances would be a more equitable way of funding highway upkeep than today's tax on gasoline and diesel fuels. That's why the European Commission wants every vehicle in Europe to be fitted by 2010 with a black-box device that can be tracked by satellite. Germany is now testing such a system for trucks, and Britain plans to require it on trucks by 2006.

Once the passive-radar cat is out of the bag, there's even a chance it could evolve into a means of tracking people on the street. “But there'd be a lot of technical challenges,” because the human body is a poor reflector of radio signals, says Shawn M. Hermans, a researcher at Numerica whose PhD thesis was on passive radar. Classified research is under way in the U.S. to create a hybrid surveillance system, using both passive radar and images from the TV cameras that now monitor many urban intersections and street corners, airports, and other public places. Suspected terrorists and other bad guys could be watched more closely.

The Big Brother implications of all this might unleash a massive public backlash. But just as plausibly, people may demand to put up with technology's double-edged sword to regain a measure of the security they have lost. ■

—By Otis Port in New York

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GETTING RESULTS

Corporate Diversity, Integration and Market Penetration

IT'S A BASIC PRECEPT OF BUSINESS SUCCESS: GO WHERE THE MONEY IS

For virtually every sector of the economy today, that principle points to diversity. The numbers make the case. Diversity purchasing power already tops an estimated \$2.5 trillion, and still growing at a much faster rate than U.S. buying power overall.

The next horizon is clear to see. Decades of change have shown bottom-line benefits through improved recruitment and retention, and enriched leadership and teamwork in-house. Various benchmarking, measurement and accountability mechanisms have shown that these workforce diversity initiatives promote the success of companies that get it right and stay—behind them.

Now smart companies are going further, aligning workforce diversity with the business world beyond their office doors. They are integrating diversity across functions and taking it out to the marketplace, cultivating communities better serving clients and garnering new customers.

How? The just-released *Management Guide for Diversity* by Diversity Best Practices, Inc., outlines leading trends today. One top area: as diversity demographics get recognized, the workforce is being tied to the marketplace through increased emphasis on diversity marketing, communication and community outreach. Another: supplier diversity is gaining business priority with billions committed to date.

Today, diversity is seen as a big business driver that can increase sales, earnings, client and customer satisfaction and market share. It can help companies do nothing less than better business.



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OPPORTUNITY

PUTTING THE BEST FACE FORWARD: MARKETING TO DIVERSE CUSTOMERS

It has become the cautionary tale of multicultural marketing. When advertisers took the very successful "Got Milk?" advertising campaign to Spanish-language media, they had too little grasp of the culture and language of their audience. They translated the tag line literally, as "Tiene leche?" But in Spanish these words ask "Are you lactating?"

Needless to say, in the Hispanic market, milk producers did not see the 9.5% jump in sales that had followed the launch of the original campaign. Why? Marketing diversity demands much more than to add color or gender or translation and stir. It requires an informed, intelligent and culturally resonant outreach to different ways of being and buying in the world.



Pfizer's long-standing commitment to diversity is expressed by such initiatives as our outreach to the Hispanic community. Our multicultural marketing, health-screening, educational and direct-to-consumer programs are now improving the health and enhancing the lives of Hispanics across America.

—Joe Bonito, VP, Global Leadership Effectiveness, www.pfizer.com

Trillions of dollars are at stake in multicultural markets, and that's just right here at home. Check the latest figures. The buying power of Hispanics—now America's largest minority group—tops \$550 billion. African-Americans wield some \$500 billion. Gay men and lesbians? \$450 billion. Asian-Americans? \$254 billion. Disabled Americans? An astonishing \$1 trillion in consumer clout. And it will not stop there. According to projections by the Selig Center for Economic Growth, by 2007, purchasing power for Hispanics will top \$927 billion; Asian-Americans will reach \$454.9 billion; African-American

purchasing potential will be more than \$852 billion.

In the effort to garner those growth dollars, companies are working to understand differences in customer buying habits. Take, for example, the sizzling Hispanic market. U.S. Hispanics already outnumber the population of Canada, but it's not just size that matters when it comes to markets. Many Hispanic households are doing better these days in part because 56% of Hispanic working women currently hold white-collar positions. As Hispanic women are making more money than ever before, they may be the market driver to reach.

Asian-American households make more money than any other ethnic

group and are over-represented in the top income brackets; yet, many advertisers don't distinguish effectively among the 20+ nationalities and cultures that the U.S. Census Bureau includes in that group. The widely-used term "Asian" (or Hispanic, for that matter) suggests homogeneity, but in fact what appeals to Chinese-Americans in California may not appeal to Indian-Americans in New York. What speaks to Japanese-Americans in San Francisco may not make sense to Filipinos in Los Angeles.

Tackling such complexities promises both new and renewed business. Not only are new customers in the

Never Underestimate the Purchasing Power of a Woman

Don't neglect the most formidable consumer force on planet Earth: women.

American women spend \$3.7 trillion a year as consumers and another \$1.5 trillion as businesswomen. They make or influence more than 80% of all consumer purchases and handle 75-85% of all family finances. For working women, that figure reaches 95%.

Long tagged as the nation's shoppers, women's purchasing behavior at times jibes with what we know about women and gender generally. Research shows that women trust relationships. They want straight talk. They learn about new products from someone they know. And they are loyal customers when products and services prove themselves worthy.

For over a century, women's choices in the marketplace were the only "vote" they ever had. Today, women still want what they buy to change the world. They are considerably more cause-conscious consumers than men. Over 40% of women surveyed recently would switch brands to help the environment, and one in five says a company's social responsibility influences her purchasing decisions, according to the Center for Women's Business Research.

Still, many key market trends defy conventional assumptions about women, reminding companies that diversity markets demand mindful attention and understanding, not lip service and stereotypes. The Business Women's Network reports that women are buying 61% of home fix-up products. A recent poll by ESPN found 85% of U.S. women are sports fans. And a 2002 study by the Consumer Electronics Association revealed that 58% of women would prefer an HDTV set to a one-karat diamond ring.

MARKET
ACHIEVER

WYNDHAM HOTELS AND RESORTS

Based on the success of their WOMEN ON THEIR WAY program, which has delivered 50% more of the lucrative women's travel market than their nearest competitors, Wyndham successfully launched a diversity effort designed to capture similar numbers among African-Americans, Asian-Americans and Hispanics.

ERNST & YOUNG

MAKING DIVERSITY WORK

AN INTERVIEW WITH ERNST & YOUNG'S RICK BOBROW, CEO, GLOBAL PRACTICE, AND CHAIR OF THE FIRM'S ETHNICITY DIVERSITY TASK FORCE

Q

Ernst & Young has a reputation as a world-class problem solver, capable of working in virtually any country and for clients in any industry. Does your diversity mission contribute to that well-earned reputation?

A. We believe that diversity is a necessary ingredient for success today at Ernst & Young, and really for any world-class business. Our organization is comprised of over 105,000 talented men and women in more than 140 countries, of all colors, religions, and with diverse interests and talents. It is through this diversity of talent and these varied perspectives that we can offer our clients incredible value.

When we at Ernst & Young talk about diversity, we also frequently use the word "inclusiveness" – meaning that every one of our people should feel valued and included because of their performance and the unique talents they bring to the organization.

Ensuring inclusiveness is more than a rhetorical flourish. Of course, it's the right thing to do, but it's also just good business. We need all our people to contribute to our success as a firm, and that means they have to feel included, engaged and empowered. So when our teams walk into any client engagement, they can provide the rich and innovative ways of thinking these dynamic environments demand.

Q. How do you ensure that diversity and inclusiveness define your corporate culture in all geographic areas and business units?

A. Buy-in at the top is essential. We put great effort into ensuring our people—especially our senior professionals—really understand their role in making our firm an inclusive place that is motivating to all people. We're very proud of the effort we've put into ensuring diversity in hiring, developing and promoting talent. Our Ethnicity Diversity Task Force, which I chair, and our Gender Equity Task Force, which is headed by the firm's chairman, Jim Turley, both include a cross-section of influential leaders. These committees are hands-on working groups that formally spearhead our diversity strategies. Through them, we set priorities, establish the right communication processes, help customize these priorities with our business units, and hold ourselves accountable for achieving certain results each year.

Q. Workforces as well as markets vary enormously worldwide. Do the same principles hold in your global operations as they do here at home?

A. My experience as Global CEO has shown me that Ernst and Young's People First strategy – our commitment to put our people first in any business decision that we make – has been very well received regardless of geographic location. Our strategy is all about respecting differences and fostering individuality – and that resonates well with people all around the world. Some things seem almost universally true: people want to have an opportunity for a challenging career; they want to be treated fairly; they want to be trained and mentored, and given opportunities to map their own careers. And they want a chance to excel both at work and in their personal lives. That's what we strive for at Ernst & Young, worldwide.

offing, but multicultural marketing may yield growth where it has been stagnant or wanting for years. Consider for starters that top diversity markets—Hispanics, African-Americans, Asian-Americans, gay and lesbian consumers, and the disabled—tend to be concentrated in urban and inner-city areas that many had long ago written off.

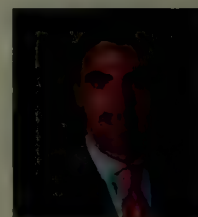
DIVERSITY B2B: EQUALLY OPPORTUNE FOR ALL

Women- and minority-owned businesses are demonstrating phenomenal success, yet the competitive power they can bring as suppliers has yet to be tapped by Corporate America. A landmark study by the Center for Women's Business Research found that only 4% of the billions spent annually on outside goods and services by leading U.S. corporations goes to women's business enterprises (WBEs).

into fewer large ones—may require more extensive redress. At the most basic level, bundling results in fewer contracts available for bidding. And since an average of 38% of corporate spending contracts are up for renewal or re-bidding annually, opportunities for new vendors shrink even more.

The National Association of Women Business Owners (NAWBO) has been calling for an end to contract bundling for years, saying an inadvertent consequence of the practice has been to put a good deal of corporate and government business beyond the reach of smaller, women- and minority-owned firms. The response by many large corporations has been to work with 1st-tier suppliers to increase diversity among 2nd-tier contractors.

Unfortunately, there is some evidence this approach is falling short so far. Only 20% of WBEs surveyed said that when their own bid for a 1st-tier contract was unsuccessful, supplier



At Deutsche Bank, we value the differences that make a difference. Why? Because

an open, respectful and inclusive work environment attracts the finest talent, and fosters creativity among teams to deliver the best possible results for our clients.

—Seth Waugh, CEO, Deutsche Bank Americas, www.db.com

on the price-to-quality axis. Nearly half of WBEs surveyed (45%) have formed joint ventures or strategic alliances to bid on a large corporate contract.

The foothold they are gaining should open more doors since corporations are seeing proof that supplier diversity delivers. Companies with strong supplier diversity records say their commitment makes bedrock business sense: they get high-quality products and services, with a minimum of red tape, at very competitive prices.

Diverse firms are certainly optimistic about the prospects. Ninety-one percent (91%) of women business owners surveyed—both those currently marketing to large companies and those not yet in the game—expect to be doing business with major corporations over the next three to five years.



The same focus on diversity that is important to Ernst & Young is increasingly important to our clients. They know, as we do, that leveraging a diverse and committed workforce is an essential element of dynamic and successful organizations.

—Rick Bobrow, CEO, Global Practice, Ernst & Young, www.ey.com

Why? A top problem for women- and minority-owned firms, cited by 70% of WBE respondents, is difficulty learning about opportunities for corporate contracts. Another major obstacle is the ever-growing practice of contract bundling (50%).

Leading corporations have begun addressing the breaks in the information pipeline by maintaining diversity supplier databases. But the issue of contract bundling—combining smaller contracts

diversity personnel put them in touch with a 2nd-tier opportunity.

As an interim strategy, some diverse companies have joined forces—even with larger competitors. In teams, small businesses can produce goods on a larger scale, and deliver on a specified-order basis, which could lead to bigger contracts down the road. And if a joint venture includes suppliers on two or more points in the production pipeline, the team can be tough to beat

This section was written by Amy Aronson, Ph.D., and produced by Medelia Communications, www.medelia.com. Design and layout by Cantor Design, Inc, www.cantordesign.com. Illustration by Dennis Harms.

**MARKET
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XEROX

When a pilot marketing program connecting Xerox with women business owners in the Northeast region achieved record gains in sales and significant ROI in the first year, the company took the program national. It currently serves over 500 Xerox agents nationwide.

A black and white photograph of two women, one Black and one white, both smiling and looking towards the camera. They are wearing dark, possibly leather, jackets. The background is dark and out of focus.

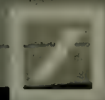
At Deutsche Bank, we don't just talk diversity. We embrace it. We're passionate about it not only because it's right, but because it leads to business excellence. With offices in 76 countries around the world, we know that it is the diversity of our employees that will propel our business success — through more creative and imaginative thinking and through greater sensitivity to the needs and expectations of our many stakeholders.

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SARS

HOW SARS OUTSMARTS THE CELLS SENT TO KILL IT

COULD A COLD make SARS symptoms worse? Thomas G. Voss of Southern Research Institute in Birmingham, Ala., suspects that previous exposure to similar pathogens—perhaps a cold caused by another corona virus—could help explain why some people get sicker than others. The theory hinges on the fact that people have two types of antibody responses to disease—one general and one specific to previous illnesses. With most diseases, levels of generalized antibody spike before levels of specific antibody do. But with SARS, both types increase at almost

the same time—just what you'd expect if SARS is cross-reacting with another virus.

So far, there is no direct evidence of such a link. But researchers have noted that cats vaccinated against a SARS-like virus get sicker than unvaccinated cats when exposed to the bug. What's more, both SARS and the cat virus propagate by latching onto antibodies and then infecting scavenger cells that normally destroy germs. That may explain why an antibody reaction leads to sicker cats—and it could shed light on the human illness as well. —Janet Ginsburg

MICROCHIPS

RADIO ID TAGS SO CHEAP THEY'LL BE EVERYWHERE

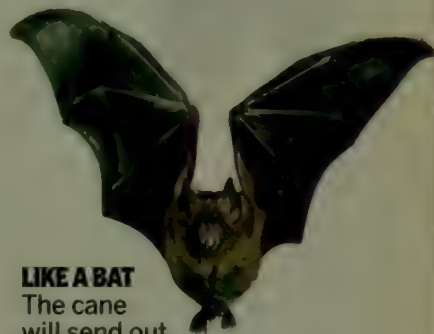
TINY MICROCHIPS known as radio-frequency identification (RFID) tags are being hailed as the Next Big Thing. That's because someday they'll probably replace the bar codes used to track goods around the world. Now, thanks to the first RFID tag with a built-in antenna, the next big thing is even teensier—and one step closer to becoming ubiquitous.

Radio tags on the market use bulky external antennas and cost about 30¢ and up. Hitachi has redesigned the antenna and embedded it in so-called mu chips, which it hopes to sell for as little as 4¢ by 2006. If so, the chip could end up in some surprising places, says Ryo Imura, head of mu chip operations. Hitachi already has fielded inquiries from several central banks that are interested in placing the chips in banknotes to thwart counterfeits. Imura points out that they could also help make driver's licenses, passports, and other paper documents more secure. —Irene M. Kunii

ASSISTIVE TECH THIS CANE HAS ITS OWN SONAR

BATS DON'T LET near-blindness slow them down. To avoid collisions while in flight, they emit high-frequency chirps and process the echoes that return from nearby objects. Now the same sort of echolocation is being built into canes that could help visually impaired humans get around.

Developed by Dean A. Waters, a biologist at



LIKE A BAT

The cane will send out pulses we can't hear

England's University of Leeds, the "ultracane"

looks like the collapsible white tapping sticks widely used today, but its handle is packed with sensors. A tiny speaker emits 60,000 pulses per second at a frequency humans can't hear. A PC-style processor then calculates how long each echo takes to return and identifies obstacles to be avoided. The stick alerts the user by sending a strong, fast vibration through one of four pads on the handle—for forward, left, right, or up.

Waters and his team are seeking outside funding to help begin manufacturing. In the meantime, they set up Sound Foresight Ltd. to handle production. The ultracanes will sell for about \$660. —Christina Passariello

What Goodyear Got From Its Union

The USW brought a plan to revitalize the ailing tire maker to the negotiating table

WHEN LEADERS OF the United Steelworkers union sat down last April to negotiate a new labor pact with Goodyear Tire & Rubber Co., they knew they were headed for trouble. After all, the nation's largest tire maker had lost \$1.1 billion in the previous year as rivals selling cheap tires made in low-wage countries sliced its market share by three points, to 19.5%. Just as bad, a revolving door of top executives had racked up a crushing \$5 billion in debt by investing in acquisitions and new tire products that didn't pan out. The union's options? Allow Goodyear to replace some of its 14 U.S. plants with ones in Asia, or fight the company with a strike that could force it into bankruptcy.

"WE'LL MAKE YOU PROFITABLE"

INSTEAD, USW PRESIDENT Leo Gerard came up with a third choice. Tapping the expertise of former Lazard Frères investment banker Ron Bloom, who joined the USW as a strategy advisor in 1996, the union hired a boutique Wall Street firm to devise a long-term strategic plan for the company. The goal: to make Goodyear globally competitive in a way that would preserve as many of the union's 19,000 jobs as possible.

In the end, that's just what happened in a new contract ratified in mid-September. The USW offered to slash labor costs by \$1.15 billion over three years and to cut 3,000 jobs. In exchange, Goodyear promised to keep—and invest in—all but two of its U.S. factories and to limit imports from its factories in Brazil and Asia. The company also promised to go along with the more aggressive debt restructuring

timetable the USW's Wall Street advisers recommended as a way to rein in management. In fact, to hold the company's feet to the fire, the USW got Goodyear to agree to pay \$1,000 to each union worker and \$500 apiece to all 22,000 retirees if the debt goals aren't met by 2007. "We told Goodyear, 'We'll make you profitable, but you're going to adopt this strategy,'" says Bloom. Says Jonathan D. Rich, president of Goodyear's North American tire business: "We got what we needed" to become competitive again.

The innovative Goodyear pact is a reprise of the strategy Gerard used to help restructure the ailing U.S. steel industry in

the past year (BW—Feb. 3). Foreign competition has savaged steel even worse than tires, driving several steelmakers into bankruptcy or liquidation. To stop hemorrhaging, the USW agreed to major job and benefit cuts, which have helped stabilize leading steelmakers. Now Gerard hopes to use the Goodyear deal as a model to pull off the same feat with other tire makers. Instead of making tires in overseas factories, he wants Bridgestone/Stone Inc. and Continental Tire North America Inc. to invest in their U.S. plants and compete via higher productivity. "We're trying to bargain public policy," says Gerard.

BREATHING ROOM

IT'S AN AMBITIOUS goal, given the wage differentials with other tire-producing countries. In Brazil, Goodyear workers just a fraction of the \$22 an hour it pays USW members. That's why the union took some painful medicine to put Goodyear's U.S. factories back on competitive footing. In addition to the cuts, USW members won't get a raise for three years. Plus, union workers and retirees will pay more for health-care coverage, saving \$50 million a year. Management also agreed to limit executive salaries, including options, and to cut salaried workforce by 15% more than hourly staff.

Will even all this be enough? UBS



ROLLIN' Danville, Va., and 11 other Goodyear factories, are safe

Saving Goodyear

The United Steelworkers and the tire maker recently signed a labor pact intended to help the company compete against low-wage rivals overseas. The deal:

THE UNION

Gave up \$1.15 billion in wage-and-benefit concessions over three years.

THE COMPANY

Promised not to outsource U.S.-made products to low-wage factories abroad and to maintain 85% of its current 19,000-person workforce. Also agreed to invest in 12 of its 14 North American plants.

Data: United Steelworkers

analyst Saul Rubin says Goodyear to close several plants, not just the one the union agreed to shutter, with a second closure if productivity gains aren't met. Plus, the \$1.15 billion slice only \$450 million off existing costs, with the remaining \$700 million coming in future wage and benefit cuts. The company now won't have to pay. Goodyear clearly has won some

breathing room. The other U.S. tire makers, whose USW pacts also expired last April, are suffering too and may be willing to go along with a similar approach. If Goodyear and the USW can figure out how to keep up as globalization drives down costs, there may be some hope that this old-line manufacturing industry can be competitive—and remain in the U.S. ■

—By David Welch in Detroit

Q&A WITH RON BLOOM

Big Labor's New Pal: Wall Street

Labor unions in old-line industrial sectors have watched for years as their well-paying jobs have been shipped off to low-wage countries. In the past year or so, the United Steelworkers union tried to enter the trend by devising new strategies for companies such as Goodyear Tire & Rubber Co. to become competitive. A key player has been Ron Bloom, who joined the United Steelworkers after helping the union from his perch as a Wall Street investment banker. After getting an MBA from Harvard Business School, Bloom, now 48, spent five years at Lazard Frères before teaming up with a colleague in 1990 to set up an investment advisory shop dedicated to helping unions do buyouts and employee stock ownership plans. In 1994, their firm advised the Air Line Pilots Assn. as it led other unions to purchase 55% of UAL from Boeing's United Airlines Inc. Two years later, Bloom was doing numerous smaller buyouts for the USW in the troubled steel industry. Bloom decided to join the union full-time. He shared his perspective with Detroit correspondent David Welch:

trouble, we try to get in and understand why the company isn't doing well.

The new Goodyear contract has terms that force the company to refinance its debt quickly and keep plants here. Are you trying to dictate management's policies?

We're trying to express a business model through collective bargaining. Other people take the low road, either by building everything someplace else or by beating up the workers to get concessions here. We think the company should be a patient, long-term builder of value for the employees and shareholders.



FIXER Bloom forced Goodyear's hand

In addition to the stipulation about refinancing the debt, the new contract limits executive pay and the use of stock options. And you won a seat on the board. It sounds like you don't trust management.

We're not going to save this company and then go back to the old ways of doing things.

Despite all the job and wage cuts the union agreed to, Wall Street analysts are saying the contract may not go far enough. Does it?

Here's the problem: Wall Street wants simple, quick answers. All they wanted to know is how many plants would be shut down. But if all the manufacturing companies run away from North America, that's not a plan. ■

Middleware. It's under the hood.

Wall Street and Big Labor don't really see eye to eye. Yet you're using investment bankers to help the union's negotiations. Why?

In Wall Street parlance, workers are secured creditors in terms of their claims on a company. So in any major restructuring with a company that's in

Middleware is Everywhere.

Can you see it?

2

4

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KEY

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Prime Time For Prime-Rate Funds

These funds can help protect you against the risk of higher interest rates. **BY MARA DER HOVANESIAN**

I NTEREST RATES ARE already well up from their 45-year lows, and with the economy improving, they are unlikely to head back down. That makes long-term bonds and bond funds, which decline in price when rates rise, a bad bet. Meanwhile, the Federal Reserve has kept short-term rates so low that money-market funds yield less than 1%—hardly an attractive solution

for the income-starved investor.

That means it's prime time for prime-rate funds (table). Also known as bank loan funds, these portfolios are comprised of loans made to corporate borrowers that are pegged to the prime lending rate, now 4%; the rates on the loans are usually prime plus 3% or so. That means the funds' yields rise along with rates.

What's more, the loans they invest in become more valuable as borrowers' creditworthiness improves with a rising economy. "In the past three years, it has paid to be in bonds with higher credit quality," says Payson Swaffield, who with Scott Page, manages \$10 billion in bank loan funds for Eaton Vance Management. "Now, with the economy slowly improving and default rates declining, the greater risk is that of rising interest rates."

Consider what happened back in 1994 when interest rates spiked. Long-term Treasury bond funds lost 6.9%, but prime-rate funds gained an average 6.6%, according to Morningstar. The group has averaged returns of 3.8% a year over the past five years (through Sept. 30) of low rates and recession, vs. 5.6% a year for long-term Treasury funds, and 5.4% a year for corporate bond funds. But prime rate funds beat money-market funds, which earned 3.4% a year.

Investors don't need mutual funds to buy T-bills or bonds, but for most, a prime-rate fund is the only way to invest in the \$1 trillion senior floating-rate loan market. These loans generally are made by banks to companies to finance buyouts or acquisitions. The loans are rated by credit agencies such as Moody's and





Standard & Poor's. They're then bundled, or syndicated, in the secondary market. Buyers are usually endowments, hedge funds, and, of course, mutual funds.

The borrowers behind these loans are not the most creditworthy. They're usually the same companies which, when they go to the bond market, are issuers of junk bonds. Still, there's less risk in these loans than investing in junk bonds. The loans are classified as senior or secured loans as opposed to unsecured or subordinated bonds. That means if a company gets into trouble, and its assets are liquidated, the holders of the senior debt will be paid before other investors. "We are basically in a favored position," says Eaton Vance's Scott Page.

PRICEY SALES CHARGES

IN ANY OF THESE FUNDS, diversification is a critical element. The Liberty Floating Rate Fund is up 11.6% so far this year, and more than half of that comes from price appreciation. Co-manager Brian Good owns loans of 161 different companies in 46 industries, and the average stake he has in any one position is less than 1% of the fund's assets. Good's returns have been helped by improving fundamentals in two main industries this year: cable TV and wireless telecom, especially in some core holdings, such as Nextel Communications, Centennial Cellular, American Cellular, Adelphia Communications, and Charter Communications.

Some bank loan funds are closed-end. Such portfolios invest like funds, but their shares trade like stocks. That means their market prices usually differ from the underlying value of the holdings. Those funds are good buys when their market price is at a discount to their net asset value. But unfortunately, that's not generally the case right now. These shares are up 25% year to date, and most of the closed-ends trade at premiums. That's why UBS analyst Jon Maier downgraded the closed-end funds to neutral this summer, after the group soared 25% in market price. "They've had a great run," he says, adding, "but it's still a good yield play and a good hedge against rates."

There are downsides to investing in bank loan funds. Often, they are expensive and sold with deferred sales charges of as much as 3%. And ongoing expenses can also be a concern—most are well above 1%. That's high for an income fund. Still, returns are reported net of expenses, so if you're satisfied with them, the funds can be a good deal.

Bank loan funds were laggards during the bust. The yields came down as the Federal Reserve kept lowering interest rates. Their credit quality deteriorated along with companies' fortunes—and that eroded their portfolios' net asset values. Prime-rate funds are not an optimal investment for all times. But with an improving economy, they are definitely coming into season. ■

A Sampler of **Bank Loan** Funds

FUND	TICKER	TOTAL RETURN*			CURRENT YIELD**	EXPENSE RATIO
		2003	3 YR.	5 YR.		
AIM Floating Rate B	XAFRX	5.64%	2.52%	3.69%	3.93	1.49%
Eaton Vance Floating Rate Hi. Inc. C	ECFHX	6.28	3.92	NA	3.08	1.91
Eaton Vance Floating Rate I	EIBLX	4.82	NA	NA	3.15	0.89
Eaton Vance Prime Rate Reserves	EVPRX	5.63	2.81	4.03	3.05	1.26
EV Classic Senior Floating-Rate	ECFRX	5.39	2.65	3.85	2.90	1.41
Fidelity Advisor Float Rate Hi. Inc. A	FFRAX	4.98	4.22	NA	3.27	1.09
Franklin Floating Rate	XFFLX	8.08	1.71	3.94	4.50	1.32
Franklin Floating Rate Daily Access A	FAFRX	5.20	NA	NA	4.07	NA
ING Senior Income Fund A	XSIAX	6.65	NA	NA	NA	1.57
Liberty Floating Rate Advantage Z	XLAZX	16.03	6.59	NA	7.56	2.02
Liberty Floating Rate Z	XLFZX	11.60	4.81	NA	5.52	0.80
Merrill Lynch Senior Floating Rate	XMPFX	11.04	2.50	3.55	NA	1.36
Morgan Stanley Prime Income Trust	XPITX	9.46	1.04	3.31	4.02	1.29
Oppenheimer Senior Floating Rate C	XOSCX	7.91	3.42	NA	4.63	1.72
SunAmerica Senior Floating Rate B	XNASX	8.71	3.42	4.51	5.60	1.45
Van Kampen Senior Loan Fund	XPRTX	11.93	1.71	2.52	3.77	1.43

*Appreciation plus reinvestment of income and capital gains before taxes, for periods ended Sept. 30

**Annualized estimated yield based on last 30 days

Data: Morningstar, Yahoo! Finance

The New Pinch In Health Coverage

Plans are costing more—again. Here's how to sort them out. **BY CAROL MARIE CROPPER**

AUTUMN IS SIGN-up season for the 161 million workers and family members covered by employer-sponsored health insurance. This year will bring more bad news: higher co-payments and larger deductibles. Some services that were fully covered, such as hospitalization, may be only 90% paid. Even so, employees are just bearing their share of a projected 12% increase in costs.

You'll see new plans, fewer options, and tweaks to old ones—so you'll need to scrutinize the choices. And this may be the year to decide if extras such as dental and vision coverage are worth the expense.

Here's what you may find in your benefits packets:

CONSUMER-DRIVEN HEALTH PLANS These will be an option at more companies this year. The plans typically give the employee a \$500 to \$1,000 kitty to pay for health care, then provide insurance coverage after perhaps the first \$2,000 in expenses. Many companies have pushed the plans the last couple of years, with about 10% of all employees having them as an option, though only about 1% have signed on. Still, this option might be for you if you're healthy—or if the medical care you need usually isn't covered anyway—and you can afford to cover the \$1,000 or so before the insurance kicks in. Any unused money in your account usually rolls over to the next year. But stay away if you're likely to use more than the initial fund, or the \$1,000 tab would be a problem.

HIGHER CO-PAYS FOR SPECIALISTS If it costs \$15 to visit the family doc, going to



BASIC Co-pays are going up, and plans may charge more for specialists

your family see lots of specialists, this can add up.

RANKING HOSPITALS Medical insurers are starting to place hospitals in tiers based on how expensive they are or on some insurance company measure of quality. Once a hospital is placed in one of the less-favored groupings, you'll face reduced coverage if you use that facility, perhaps paying a \$500 deductible rather than \$200. If your company offers such a plan, find out which hospital your doctor sends patients to and how it ranks. Also, ask yourself if you're the sort who wants an expensive, cutting-edge teaching hospital when you're sick—and whether you would rather

pay for that with higher premiums or simply absorb the greater cost should you ever need care.

HEALTHY BEHAVIOR INCENTIVES So many companies are offering incentives to encourage workers to improve their health, by, say, losing weight or quitting smoking, says Mohit Ghose, spokesperson for the American Association of Health Plans, an insurers' trade group. The T Health Plan awards points for healthy behavior that you can trade for vacation discounts and other goodies. If you've been planning to go to the gym and want to take a trip to Hawaii, this could be your personal version of synergy.

DENTAL AND VISION COVERAGE General medical

coverage is a no-brainer. Who wants to face the cost of catastrophic medical bills? But the cost of glasses or contact lenses is more easily managed. Dental insurance comes with a \$1,000 to \$2,000 annual payment limit, so pricey dental treatments are not guaranteed to be covered in full anyway. Richard Ostuw, a health-care consultant and human-resources advisor at Towers Perrin, suggests that employees first figure out how much of the dental and vision premium your company picks up

there's little or no subsidy, as is often the case with vision plans, then the policy is likely no bargain.

The real test is to compare how much you would likely spend without coverage vs. what the premiums, deductibles, co-pays, and uncovered treatments together would cost you. (Few plans fully cover designer eyeglass frames, for example.) For some, signing up for the coverage every other year and timing checkups at the beginning and end of the year might make sense. Of course, the security of paying a set premium every month rather than \$1,000 for a root canal before Christmas is worth something. And, adds Ostuw, dentists and ophthalmologists often charge uninsured patients more.

Whatever options you choose, they're simply going to cost you more. At least make sure you're plunking down the extra bucks for the plan that seems to be your best. ■



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STYLISH INTERIOR
The Quest's controls are on the central console.

A New Oxymoron: Hip Minivan

The latest Toyota and Nissan models sport lush interiors and smart designs. **BY DAVID WELCH**



environmental controls. It's a nice touch that first appeared in Toyota's Lexus 300 luxury SUV. The stick shift adds a little panache and it's easy to reach. Wood trim around the stereo knobs and on the steering wheel make the Sienna seem more like a Lexus than a Toyota brand vehicle.

This van really goes the extra mile for comfort, too. The leather seats in the level Sienna XLE Limited rival any mass-class airline seat that I've ever seen. All of the passenger seats are roomy. Seats in the third row can be folded down, the floor or the second-row seats can be removed to create a big cargo space.

SMOOTH RIDE

WHEN IT COMES TO THE DRIVE, the Sienna is probably the smoothest minivan on the market. Like most Toyotas, it most removes the driver from the road, practically glides over bumps and potholes. And it is incredibly quiet.

QUIET Toyota's Sienna practically glides over bumps and potholes.

IT'S HARD TO FIND A VEHICLE less hip than a minivan. When I picked up a 2004 Toyota Sienna minivan for a test drive a month ago, I held the keys at arm's length between my thumb and forefinger, as if a stray dog had just slobbered all over them. These days, many buyers who need passenger space have opted for the more rugged sport-utility vehicles over the tame minivans. How uncool are they? General Motors now calls its minivans "crossover sport vans."

But don't tell the big Japanese car-makers that minivans are uncool. After seeing the success of Honda Motor with its hot-selling Odyssey over the past two years, Toyota Motor and Nissan Motor want a piece of the action. Both companies have cool new minivans. When I jumped in Toyota's Sienna, the interior was so luxurious that I forgot I was in a

van. Bedecked with all the swank appointments like heated leather seats, the Sienna can cost nearly \$40,000. And give Nissan points for creativity: The new Quest has some sharp styling and innovation, including the Skyview roof.

Toyota's early minivans were undersized and not really competitive, but the new Sienna quickly jumps to the head of the class. When I slid into the cockpit, the first thing I noticed was that the stick shift is located on a low section of the dashboard and just beneath the en-



Cordless—and Hands-Free, Too

How headset phones stack up. **BY LARRY ARMSTRONG**

I ONLY WANTED A NEW CORDLESS phone, something that would let me roam around the house and get stuff done while I'm on the phone. I envisioned something like a cell phone, a good-looking, pocket-size phone loaded with high-tech features.

Then I went shopping. Nothing svelte. Nothing small. Nothing light enough to hang—without risk—from the waistband of the sweats or flannel boxers that I lounge around in.

CALLING CARDS

WHAT I DID FIND was a category of cordless units called headset phones. There's no clunker of a handset at all, just a tiny dial pad with a jack for a headset, which is included and in fact is the only way you can use the phone. When you're not on the phone, the portable part nestles into a tabletop base station and recharger unit that plugs into a phone jack. I tried three: Uniden's Neo TRUC46, a Plantronics CT12, and the 26977 cordless headset model from GE Consumer Electronics.

My favorite by far was the \$80 Uniden Neo. It and the Plantronics, about \$110 to \$120, are the size of a credit card, but the Neo is only a half-inch thick, vs. one inch for the Plantronics. At 2.3 ounces, it weighs a third less, too. It comes with two headsets, over-the-head and over-the-ear models. The Plantronics headset can work either way, and has a tiny light that blinks when you're on the phone, a nice touch when you're working at home.

Otherwise, the two work identically. They have a three-

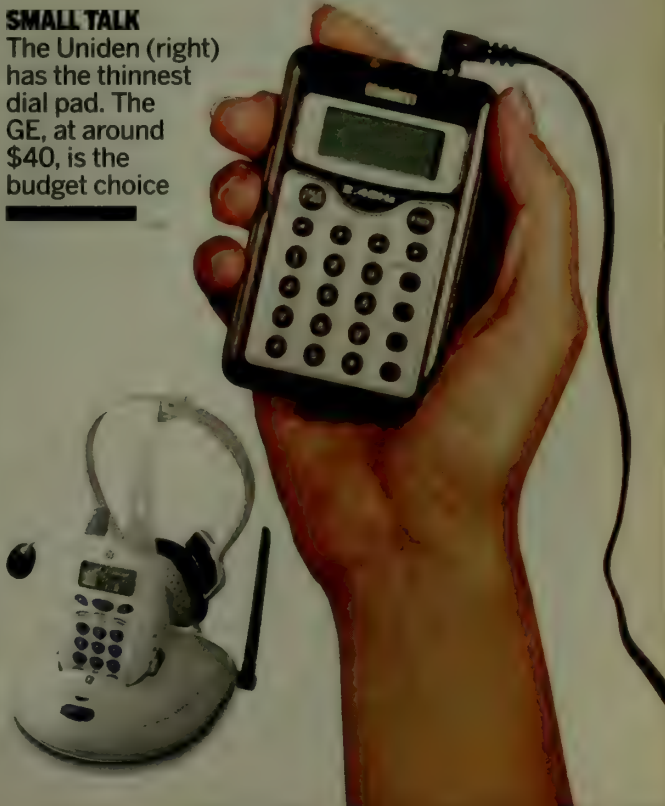
line LCD display, storage for 100 names and phone numbers, 10 ring tones (the Neo has a vibrate mode as well), and batteries good for five hours of continuous talk between charges.

The GE 26977 is bigger, like a deck of cards, and not as capable. It stores 40 numbers, and only those captured by Caller ID (though it has 10 programmable speed dial slots as well). At \$35 to \$45, it's a good budget choice. Because it operates in the older 900-megahertz radio band, it could be less susceptible to interference than the other two, which share the 2.4-GHz frequency with home Wi-Fi networks and microwave ovens.

Don't expect sexy flips, color displays, or the ability to sync phone numbers with those on your PC. But if you want a cordless phone that fits in a pocket or even clips to the neck of your T-shirt, any of these would be a good call. ■

SMALL TALK

The Uniden (right) has the thinnest dial pad. The GE, at around \$40, is the budget choice



(BELOW) PHOTOGRAPHS BY ROGER KENNY

river can even have a quiet conver-

n with third-row passengers. couldn't say the same for the ot. Nissan's new minivan has a de- ride, but it's not as comfy as the na. That was apparent pretty dy when I took it for a spin. The t takes bumps a little harder than

the Sienna does. On rough roads, I could feel the pavement sending vibrations up through the tires. The Quest also deals more road noise.

What it lacks in refinement, the Quest makes up for in brawn.

Nissan's formula

days is bigger and more powerful nearly everything that it builds.

Quest has the same 3.5-liter V-6 ne that Nissan has been stuffing many of its models. And the en- gives this minivan some gusto.

Quest powers ahead with 240 power, 10 more than the Sienna. It's also one of the roomiest mini- on the market. Another bonus: Quest's sliding door is the biggest e business, so it's easy to climb in out of the vehicle.

Quest is easily the most artisti- stylish van, but in some spots Nis- sacrificed substance in the name of

Most of the dashboard controls on a round section of the dash- d that protrudes from the floor at angle, like the Tower of Pisa. It's not practical. To load CDs, I had to a down into the middle of the er," and it was hard to see where I putting the disk. Also, the gauges ne dash are small and difficult to

One great feature, however, is the second- and third-row seats beneath the floor to create a big o area without having to lift out eats.

r the money, the Sienna is a better At the low end, the Quest starts at 500, about \$1,500 more than the na. I drove loaded versions of both

With equipment like onboard players for the kids and head- es in the back seats, the Toyota \$39,000 and the Quest was about 000. But given the Sienna's nicer ior and all-wheel drive, it was eas- ne better choice for the discrimi- ng minivan buyer. ■

Earnings: What To Listen For

This time out, revenue growth will have more impact than cost-cutting on stock prices.

BY DAVID HENRY

AS COMPANIES REPORT third-quarter earnings in coming weeks, you'll see big gains, perhaps as much as 20% higher than a year ago, according to Thomson First Call. Confidence is high because fewer companies than usual have put out the dreaded warnings that they'll come up short. About 85% of companies will report earnings that meet or beat estimates, says Nick Raich, research director at Zacks Investment Research.

That's one reason the stock market has climbed so much this year, with the Standard & Poor's 500-stock index gaining 18% and the NASDAQ 42% through Oct. 6. But it is also the reason this earnings season will be less about looking at a chief executive's numbers than about reading lips. Can the CEO describe a revenue stream strong enough to keep earnings growing in the fourth quarter? Are the comments about 2004 positive enough to keep the stock aloft? "The stocks are going to be trading off of what they say about the fourth quarter and 2004," says Raich.

Pay particular attention to comments in press releases and investor conferences about top-line growth. Companies have achieved much of their earnings rebound to date by cutting expenses. To keep the earnings momentum, they will need additional business as well. That's particularly true among S&P 500 technology stocks, where analysts expect earnings to be up 30% in the fourth quarter and 31% in 2004. Lis-

ten closely for clues about a company's operating leverage. That's what will be needed to turn incremental revenues into bigger profits, says Pip Coburn, global technology stock analyst at banking giant UBS.

TECHNOLOGY COMPANIES

TECH STOCKS are the most likely to make the big moves. Besides the stocks being among the most volatile in the market, the companies have some of the highest five-year projected earnings growth rates (14%) and the most vulnerably high price-earnings ratios, around 28 times earnings for the next four quarters. Many will be all ears for Intel's conference call on Oct. 14. Analysts are forecasting a 37% profit gain for the chipmaker in 2004, and traders will be listening for comments to support that number.

The next day, IBM is expected to weigh in, and those results could well move the stocks of its competitors, including hardware maker Hewlett-Packard, Web-infrastructure company BEA Systems, and tech-service companies Accenture, Computer Sciences, and Electronic Data Systems. On Oct. 23, Microsoft will Webcast its earnings call after the markets have closed—and that always has ramifications for tech stocks.

FINANCIAL COMPANIES

WHILE TECH STOCKS account for 18% of the value of the S&P 500, the financial sector has the biggest weighting at 21%. On Oct.

14, Bank of America will be among first banks to report. It could provide early clues to profit trends at banks. J.P. Morgan Chase, U.S. Bank, Wachovia, and credit-card company MBNA are expected to report over next week. Anything they say about financial health of consumers who helped carry the economy could interest. Pay attention, too, to the ink of rising long-term interest rate profits. That will be important as rates continue to rise.

CONSUMER COMPANIES

CONSUMER STOCKS heavily influenced by economic cycles, such as auto and media companies, and retailers, make up 11% of the S&P 500. General Motors reports Oct. 15 and Ford Motor the day after. They should provide additional insight into consumer spending and an update on pension funding problems affecting older industrial companies. Time Warner's report, expected Oct. 16, will be scrutinized carefully for clues to see if it can deliver the 17% earnings growth in 2004 that Wall Street expects. Most retailers won't be reporting until November. ■



**Banks
may offer
clues on
how rates
will affect
profits**



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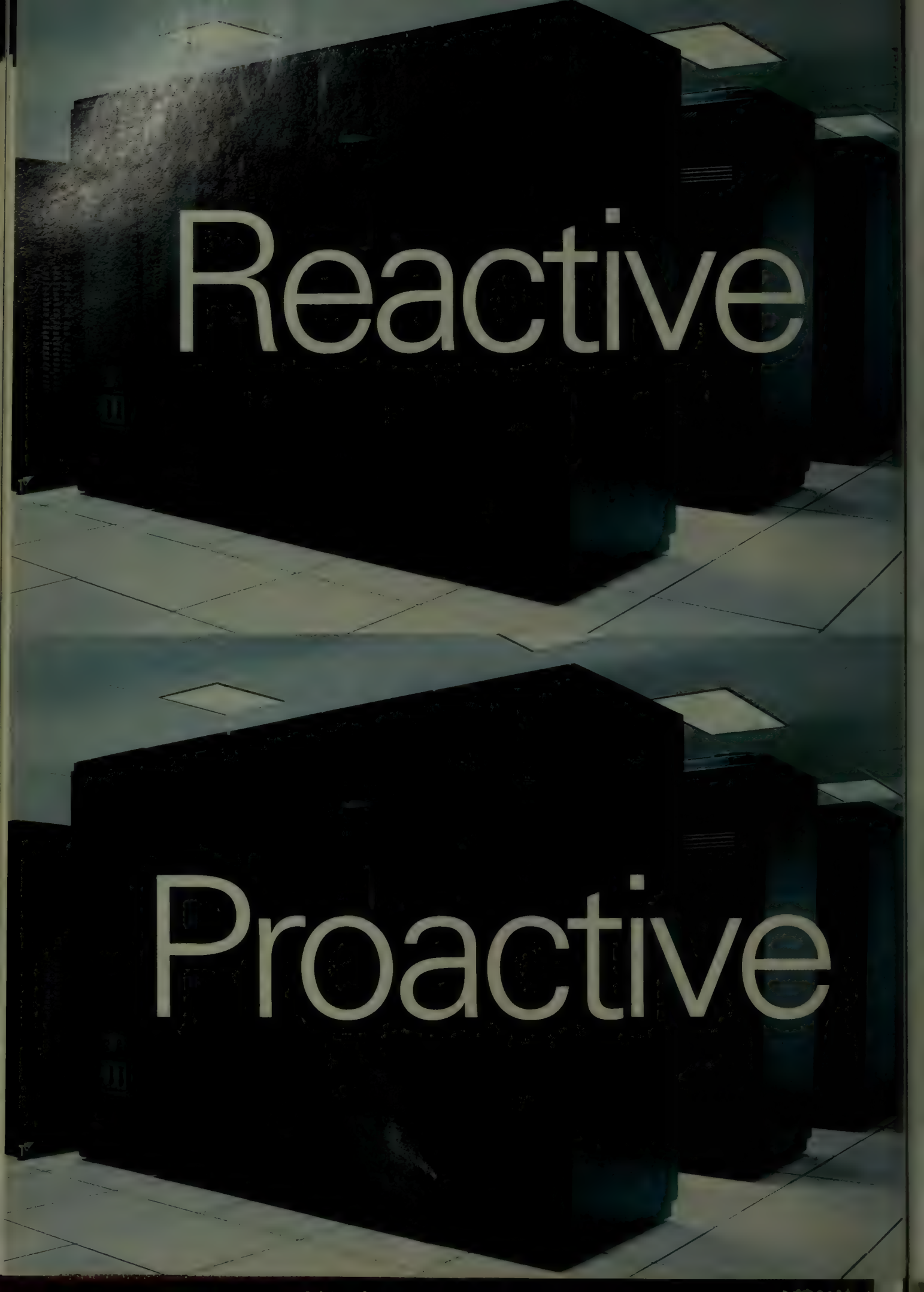
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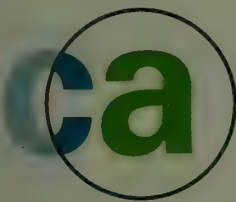
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EDITED BY TODDI GUTNER



GAMES

TAKE ME BACK TO THE BALL GAME

IT'S FANTASY BASEBALL from a bygone era. Toymaker **Cadaco** has brought its **All-Star Baseball** out of retirement, and it plays just like the original 1941 board game. You manage a team of All Stars with a spinner and a deck of cardboard disks customized with each player's stats. This new version (\$30) comes in a tin with a molded plastic stadium inside and is available at toy and game retailers. To find a dealer, call 800 621-5426. Or pick up earlier editions on eBay for \$10 to \$25.

FINANCE

Art Equity Loans

GOT ART? IF YOUR walls are adorned with Degas and de Koonings, you can turn your homegrown museum into a source of cash by using it as collateral for a low-interest loan. **Citigroup Private Bank**, for one, extends loans backed by art to select clients. Current interest rates are about 2 to 3 percentage points above the London interbank offered rate (LIBOR), which translates into a rate of about 3% to 4%. That sure beats taking out a home-equity loan at 6.3%, the national average.

Citi has seen demand for such loans rise by 20% for two years running, says Suzanne Gyorgy, business manager for Citi's art-advisory service, a division of the private bank that helps clients value, buy, insure, and sell art. Most clients are tapping the value of their art to expand collections or invest in stocks, Gyorgy says. Of course, you can't borrow against just any old painting. At Citi, you'll need a collection worth \$10 million to qualify for the minimum-size loan of \$5 million. That's not a problem for most clients, though, since the private bank's average account size is \$10 million. —Anne Tergesen



INTERNET

AN ESTIMATED 57% of Americans now pay at least one of their bills online, **up from 17% in 2000**, according to a new survey by market researcher InsightExpress. Of the remaining 43% who don't use online payment, over three-quarters fear that the sites aren't secure. Another obstacle: Some Mac users complain that they can't use many of the online banking programs.



MONEY

CASH CARDS FOR TRAVELER

HERE'S A WAY to say bon voyage: with TravelFunds Card from **American Express**. Put, say, \$2,500 on the card and the user can swipe it like a credit or debit card at locations that take AmEx. The cards cost \$14.95.

They're good for three years and refillable. You can get a refund within 24 hours if the card is lost or stolen. (For more info call 1-888-412-6945 or go to americanexpress.com/travelfunds)



Online Bill Payment

Some like it because they can...

Others don't, because of...

Pay bills in less time	77%	Security concerns	76%
Make last-minute payments	74	Unwillingness to pay fees	62
Visit the post office less often	58	Inability to configure computer	42
Save money on postage	56	Lack of recourse for errors	42

Data: InsightExpress

A composite image featuring a woman's face in profile, her hand near her mouth, and a yellow measuring tape. The background is filled with various food items, including a green bell pepper, a red chili pepper, and several yellow eggs. The overall color palette is warm, with yellows, oranges, and greens.

If we are what we eat,
the future is looking beautiful.

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For 100 years, ADM has worked with innovative food companies and the American farmer to find natural ingredients that boost taste and improve health. Right now, ADM is providing heart-healthy alternatives with foods from soy. And on the horizon are vegetable oils that help you curb fat and lose weight.

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BY ROBERT BARKER

Newell Rubbermaid: Why It'll Bounce Back

How cold is Newell Rubbermaid? Let's just say Wall Street is so disgusted with the big housewares maker that in July, the last time CEO Joe Galli talked to analysts, he had to plead: "Maybe give us a little credibility." Sorry, Joe. The stock sank 17% that day and 10% more after Galli canceled an October meeting set to wow analysts with new products and the business outlook.

This is why the next time a pair of CEOs predict a merger of their companies will create synergies, you should tell them to stuff it in a 32-gallon Rubbermaid trash can. In the 10 years before the Rubbermaid deal, Newell's shareholders had grown used to annual average total returns of nearly 23%—

CASH STASH:

Familiar brands—and strong cash flow—can help the company survive the current crisis



Rubber Trouble

While Rubbermaid provides the largest share of its parent company's sales, its contribution to profits has been unimpressive.

COMPANY	SEGMENT SALES	% OF SALES	OPERATING INCOME	% OF O.I.	CAPITAL SPENDING	% OF C.S.
Rubbermaid	2592	35	215	27	135	56
Sharpie	1909	26	323	41	41	17
Irwin	1727	23	136	17	46	19
Calphalon Home	1226	16	120	15	17	7

Dollar figures, in millions, are for 2002

Data: Company reports, *Business Week*

four percentage points ahead of the Standard & Poor's 500 stock index. In 1998, when Newell agreed to buy Rubbermaid with \$5.8 billion worth of its stock, the two companies enjoyed a total stock market value of \$12 billion. Today, at \$22 a share, Newell Rubbermaid brings about half of that.

Investors can't hang this merger from hell on Galli; he came in as CEO from Amazon.com in 2001. And, even if Newell Rubbermaid has been guilty during his tenure of promising the Street too much, too fast—in July, he lowered earnings guidance for 2003—the company is on a sound footing than recent action in its stock implies. I can't give odds on whether Galli will survive the current crisis—and isn't talking. But as I see it, if he does survive it'll be because the company shows solid progress and the stock recovers; if he doesn't, the stock will rally on hope of better management.

UNDERLYING THE TURMOIL is a steadily profitable, if slow-growing, maker of a gazillion everyday things: Rubbermaid containers, of course, plus Little Tikes toys, Sharpie, Park and Waterman pens, Calphalon cookware, and Levolor blinds. In the 12 months ended June, these products and more brought \$262 million in net profit on revenue of \$7.7 billion. Operating cash flow came to \$711 million.

A nagging problem, however, is where all that cash flows next. Of the \$711 million, \$339 million went to capital projects. Of that, Rubbermaid consumed the greatest share among the company's four segments. Yet Rubbermaid in 2002 contributed just 35% of sales and even less of the company's operating profit (table). No one doubts that Newell wildly overpaid for Rubbermaid. The persistent question is whether it's continuing to overpay by plowing so much cash back into Rubbermaid's new-product programs and productivity initiatives. Results in the first half ended June when Rubbermaid sales grew just 1.4% and operating income actually fell 5%, suggest the answer is yes.

So why do I see opportunity in Newell Rubbermaid? Because whether it's Galli or another executive who does squeezing greater returns for shareholders out of a long-established company with familiar brands, strong operating cash flows, and a manageable balance sheet—total debt about half of capital—is a far less daunting endeavor than, say, inventing and selling the next-generation cell phone. In other words, is already coming in the door, and investors now are getting annual dividends of 84¢ a share. That's a 3.8% yield on a \$22 stock that trades for 0.8 times sales and 13 times the Street's most bearish estimate of next year's earnings. Get 'em while they're cold. ■

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BY GENE G. MARCIAL

RIVAL CASINOS COULD BE EYEING BEATEN-DOWN **BOYD GAMING**

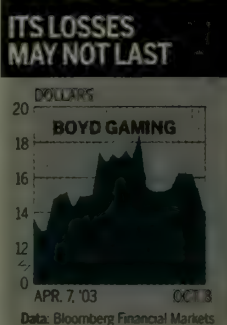
RADWARE'S NET-MANAGEMENT GEAR IS SET TO SELL BRISKLY.

A NEW THERAPY FROM **IMMUNE RESPONSE** WILL HELP SLOW HIV

Boyd: More Buyout Bait?

Boyd Gaming (BYD) got clobbered on Oct. 6. Its shares dived 10%, to 13.57, after Boyd warned that third-quarter earnings would be below estimates. But some pros are not apologizing for owning Boyd. They're buying more stock in this owner or operator of 13 casinos—including Stardust in Las Vegas and Borgata in Atlantic City. Says Jason Ader, a gambling analyst before forming Hayground Cove Asset Management: "I've been buying, as Boyd sports the lowest price-earnings multiple in its group." With the stock cheap and consolidation on the rise, Ader sees Boyd as takeover bait. MGM Mirage, which co-owns Borgata, may go after Boyd, he says. MGM is 51% owned by the acquisitive Kirk Kerkorian.

Ader has also heard that casino mogul Steve Wynn is interested: He's building a new casino in Las Vegas close to Stardust. Ader puts Boyd's worth at 22 based on recent deals. Joyce Minor of Lehman Brothers, which has done banking for Boyd, still has an "overweight" on Boyd. She thinks the bad news is confined to earnings woes at Stardust, Boyd's weakest, and Boyd's Par-A-Dice Casino in East Peoria, Ill., where gambling taxes rose in July. Minor says Boyd will earn 87¢ a share in 2003 and \$1.19 in 2004. Spokesman Rob Stillwell says CEO William Boyd, whose family owns more than 50% of Boyd, is more attuned to buying than selling. On buyout chatter, Stillwell says: "I guess we should say: 'Never say never.'" MGM didn't return calls. Steve Wynn was unavailable for comment.



Traffic Is Heavy At Radware

Radware (RDWR) is a maker of Net traffic-management gear, operating in the shadow of giants Cisco Systems and Nortel Networks. Yet tiny Radware's stock has handily matched larger rivals, zooming from 10 in April to 21.31 on Oct. 8. Radware systems let users optimize performance of servers, security devices, and Net applications. Steve Kamman of CIBC World Markets notes that, during the tech bust, Radware went after a small niche market—providing sophisticated clients with customized services that brought higher fees. Kamman says this will boost earnings, helped by a rise in both repeat and new customers. Kamman, who rates the

stock "outperform," says Radware has \$130 million, or \$7.50 a share, in cash, and no debt. Repeat customers (45% of sales) include Fannie Mae and Verizon. Among new clients (55% of sales) are Total and Japan Airlines. Mark Sue of C.E. Unterberg Towbin, which has done banking for Radware, says a "broadening pipeline" of application switches bodes well for third- and fourth-quarter earnings. So despite Radware's high p-e, Sue rates it a buy based, in part, on "solid visibility" of earnings ahead—31¢ share in 2003 and 52¢ in 2004, vs. a loss in 2002.



How Immune Response Targets AIDS

Immune Response (IMNR), co-founded in the late 1980s by Dr. Jonas Salk, developer of the polio vaccine, has talked to two drugmakers as possible partners for its drug Remune. This is an immune-based therapy for HIV patients who haven't yet taken antiretroviral drugs (the so-called cocktail). Now in Phase 2 clinical trials in Spain and having just started tests in Italy, Remune is aimed at slowing the advance of HIV and delaying the need for antiretroviral drugs, which have toxic effects. CEO John Bonfiglio says Remune boosts the immune system to attack HIV and stimulates HIV-specific immune responses. Confirming his talks with possible partners, Bonfiglio says a partnership would speed tests. Robert Wasserman of Dawson James Securities says a marketing partner would boost the stock and enhance approval of Remune in three to five years. He rates the stock at 2.45 a share, a buy—with a 12-month price target of \$8. Jacobs of Capital Growth Equity Fund, which owns shares, reports that earlier trials were "promising."



BusinessWeek online Gene Marcial's Inside Wall Street is posted businessweek.com/today.htm at 5 p.m. on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor the firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

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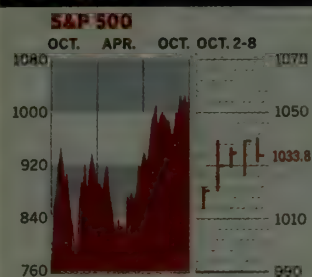
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Figures of the Week

STOCKS



COMMENTARY

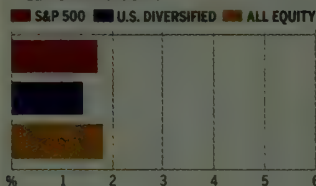
Equities tried to make it six winning sessions in a row before finally stumbling on Oct. 8. The report of a rise in September payrolls helped drive the markets higher. The jobs news, along with cost-cutting by companies, is a recipe for good profits. Also helping equities was a placid Treasury market. For the week, the NASDAQ, S&P 500, and the Dow all rose smartly.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

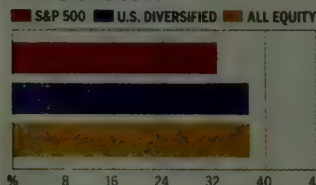
4-WEEK TOTAL RETURN

WEEK ENDING OCT. 7



52-WEEK TOTAL RETURN

WEEK ENDING OCT. 7



Data: Standard & Poor's

U.S. MARKETS

	OCT. 8	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
S&P 500	1033.8	1.5	17.5	29.5
Dow Jones Industrials	5630.9	1.7	15.5	28.4
NASDAQ Composite	1893.8	3.4	41.8	67.7
S&P MidCap 400	534.4	2.5	24.3	38.7
S&P SmallCap 600	248.9	2.8	26.6	40.4
Wilshire 5000	10,038.6	1.8	20.3	32.9

SECTORS

			% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
BusinessWeek 50*	593.4	0.8	9.4	14.1
BW Info Tech 100**	334.6	3.1	17.2	38.9
S&P/BARRA Growth	525.4	1.2	17.1	24.8
S&P/BARRA Value	504.8	1.9	18.0	34.8
S&P Energy	202.4	1.5	10.5	17.0
S&P Financials	356.8	1.7	20.2	36.4
S&P REIT	111.5	2.7	22.7	30.6
S&P Transportation	183.0	1.3	7.7	14.2
S&P Utilities	112.0	0.1	14.5	32.4
GSTI Internet	144.1	7.5	92.9	150.0
PSE Technology	651.7	3.7	42.2	75.6

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	OCT. 8	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1012.0	2.0	19.8
London (FT-SE 100)	4253.6	2.4	8.3
Paris (CAC 40)	3248.6	1.8	6.0
Frankfurt (DAX)	3395.3	2.0	17.4
Tokyo (NIKKEI 225)	10,542.2	1.7	22.9
Hong Kong (Hang Seng)	11,720.8	4.4	25.7
Toronto (S&P/TSX Composite)	7569.3	0.8	14.4
Mexico City (IPC)	7812.1	-1.6	27.9

FUNDAMENTALS

	OCT. 7	WEEK AGO
S&P 500 Dividend Yield	1.60%	1.67%
S&P 500 P/E Ratio (Trailing 12 mos.)	28.9	27.6
S&P 500 P/E Ratio (Next 12 mos.)*	17.6	17.3r
First Call Earnings Surprise*	13.77%	5.95%

TECHNICAL INDICATORS

	OCT. 7	WEEK AGO
S&P 500 200-day average	934.9	911.6
Stocks above 200-day average	84.0%	80.0%
Options: Put/call ratio	0.69	0.81
Insiders: Vickers NYSE Sell/buy ratio	5.23	5.00

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Divsfd. Metals & Mining	16.2	Internet Software	307.5
Footwear	12.0	Compr. Stge. & Perphs.	187.0
Homebuilding	11.9	Divsfd. Metals & Mining	169.6
Internet Retailers	11.6	Wireless Services	159.1
Home Entertainment	10.1	Office Electronics	136.8

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Photographic Products	-25.8	Health-Care Facilities	
Advertising	-9.7	Photographic Products	
Semiconductor Equip.	-8.3	Brewers	
Movies & Entertainment	-8.1	Soft Drinks	
Instrumentation	-6.5	Health-Care Distributors	

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Japan	8.7	Technology	93.6
Diversified Pacific/Asia	6.1	Communications	66.6
Real Estate	4.8	Latin America	58.4
Diversified Emerging Mkts.	4.4	Precious Metals	54.7
LAGGARDS		LAGGARDS	
Precious Metals	-1.9	Domestic Hybrid	21.2
Health	-1.3	Miscellaneous	22.6
Small-cap Growth	1.0	Health	27.6
Technology	1.1	International Hybrid	28.2

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Third Millennium Russia	15.3	Profds. Intnet. Ulstr. Inv.	292.6
T. R. Price E. Eur. & Mdn.	14.6	Jacob Internet	256.5
American Heritage	14.3	RS Internet Age	198.6
CGM Realty	14.0	Apex Mid Cap Growth	193.3
LAGGARDS		LAGGARDS	
ProFunds Pr. Mtlis. U. Inv.	-6.5	Rydex Dyn. Vent. 100	-74.4
Rydex Precious Metals	-5.3	ProFunds UltSh. OTC Inv.	-74.3
Pfds. Biotech. Uscr. Inv.	-5.2	Frontier Equity	-54.4
Centurion Csl. Mt. NI. C	-5.1	ProFunds UltBear. Inv.	-48.9

INTEREST RATES

KEY RATES

	OCT. 8	WEEK AGO
Money Market Funds	0.62%	0.62%
90-Day Treasury Bills	0.90	0.94
2-Year Treasury Notes	1.62	1.44
10-Year Treasury Notes	4.24	3.93
30-Year Treasury Bonds	5.16	4.89
30-Year Fixed Mortgage†	5.99	5.74

†BancQu

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	WEEK AGO	YTD
General Obligations	3.81%	
Taxable Equivalent	5.44	
Insured Revenue Bonds	3.76	
Taxable Equivalent	5.37	

THE WEEK AHEAD

RETAIL SALES Wednesday, Oct. 15, 8:30 a.m., EDT »

September retail sales are forecast to have inched 0.1% higher, after a 0.6% increase. That's based on the median forecast of economists surveyed by MMS International. Excluding vehicles, sales probably grew 0.4%, after a 0.7% jump in the previous month.

BEIGE BOOK Wednesday, Oct. 15, 2 p.m., EDT » The Federal Reserve will issue its summary of

regional economic activity before its Oct. 28 policy meeting. Economists surveyed by MMS International expect no change in interest rates.

CONSUMER PRICE INDEX

Thursday, Oct. 16, 8:30 a.m., EDT » Consumer prices for goods and services in September very likely rose 0.3% for a second month in a row. Minus food and energy, prices probably moved up 0.2%, after a 0.1% gain.

INDUSTRIAL PRODUCTION

Thursday, Oct. 16, 9:15 a.m., EDT » September factory output very likely increased 0.4%, on top of a 0.1% rise in August. The average operating rate probably reached 74.8%, from 74.6%.

RESIDENTIAL CONSTRUCTION

Friday, Oct. 17, 8:30 a.m., EDT » Housing starts in September very likely eased to an annual rate of 1.79 million, from a pace of 1.82 million in August.

The BusinessWeek production climbed to 201.7 for the week Sept. 27, up 5.4% from the before. Before calculation of a four-week moving average, the improved to 202.7.

BusinessWeek on

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/e

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The Companies

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

A

Abercrombie & Fitch (ANF) **19**
 Accenture (ACN) **158**
 Adaptec (ADPT) **66**
 Adelphia **152**
 Adventis **66**
 Aetna (AET) **42**
 Amazon.com (AMZN) **66**
 American Airlines (AMR) **14, 106**
 American Cellular **152**
 American Electric Power (AEP) **82**
 American Express (AXP) **19, 106, 162**
 American Research Group **127**
 America Online (TWX) **16, 19, 66**
 Apollo Management **120**
 Apple Computer (AAPL) **66**
 art.com **98**
 auOptronics (AUO) **62**
 Avtec Systems **137**

B

BAE Systems (BAESY) **137**
 Bank of America (BAC) **19, 42, 50, 106, 158**
 BEA Systems (BEAS) **158**
 BenQ **62**
 Best Buy (BBY) **19, 62**
 BHP Billiton **56**
 Biotech (BVT) **13**
 BMC Software (BMC) **166**
 Boeing (BA) **86**
 Boyd Gaming (BYD) **166**
 BP (BP) **60**
 Bridgestone/Firestone (BRDCY) **148**
 Brunswick UBS (UBS) **60**

C

Cadaco **162**

Cambria Consulting **86**
 Capital Growth Equity Fund **166**
 CBS(VIA) **100**
 Centennial Cellular (CYCL) **152**
 C.E. Unterberg Towbin **166**
 Chancery Lane Capital **120**
 Charter Communications (CHTR) **152**
 ChevronTexaco (CVX) **60**
 Chrysler (DCX) **13**
 CIBC World Markets **166**
 Circuit City Stores (CC) **62**
 Cisco Systems (CSCO) **16, 166**
 Citigroup (C) **50, 118, 162**
 CNET Networks (CNET) **24**
 Computer Sciences (CSC) **158**
 Continental Tire **148**
 Corporate Library **118**

D

DaimlerChrysler (DCX) **54**
 Dawson James Securities **166**
 Dell (DELL) **28, 62**
 Deutsche Bank (DB) **40**
 DirecTV (GMH) **56**
 Duke Energy (DUK) **56**
 Dynetics **137**

E

Earthlink (ELNK) **19**
 Eaton Vance Management **152**
 Edison International (EIX) **72**
 Electronic Data Systems (EDS) **158**
 Enron (ENRNQ:PK) **56**
 Exxon Mobil (XOM) **60**

F

Fannie Mae (FNM) **166**
 FirstMerit Bank (FMER) **14**
 First USA **14**
 Ford (F) **42, 54, 86, 158**
 Fox (FOX) **56**

G

Gateway (GTW) **28, 62**
 GE Capital (GE) **94**
 General Electric (GE) **157**
 General Motors (GM) **13, 54, 156, 158**
 Goodyear Tire (GT) **148, 149**
 Google **40**

H

Hayground Cove **166**
 HealthSouth **19**
 Hewlett-Packard (HPQ) **28, 36, 158**
 Hitachi (HIT) **147**
 HOB Entertainment **66**
 Honda (HMC) **156**
 Hunton & Williams **46**

I

IBM (IBM) **46, 158**
 ICANN **16**
 Immune Response (IMNR) **166**
 InfoCom **16**
 InsightExpress **162**
 Intel (INTC) **36, 94, 158**
 Interpublic (IPG) **100**
 Intuit (INTU) **40**
 iSupply **62**

J

Japan Airlines **166**
 JetBlue Airways (JBLU) **19**
 J.P. Morgan Chase (JPM) **120, 158**

K

Kohlberg Kravis Roberts **120**

L

Lawrence Equipment **36**
 Lazard **148, 149**
 Lehman Brothers (LEH) **156**
 LG **62**
 Liberty Floating Rate Fund **152**
 Lockheed Martin (LMT) **42, 137**

M

Marathon Oil (MRO) **72**
 Matsushita (MC) **62**
 MBNA (KRB) **158**
 Mercer Human Resource **154**
 Merrill Lynch (MER) **16, 50, 86, 106**
 Metal Management (MTLM) **14**
 MGM Mirage (MGG) **16, 166**
 Microsoft (MSFT) **24, 28, 66, 158**
 Millennium Partners **50**
 Mitsubishi **28**
 MMS International **40**
 Moody's (MCO) **152**
 Moore Wallace (MWI) **120**
 Morgan Stanley (MWD) **19, 33**
 Motorola (MOT) **56**
 Musicmatch **66**

N

Napster **66**
 NBC (GE) **56**
 Newell Rubbermaid (NWL) **164**
 News Corp. (NWS) **56**
 Nextel Communications (NXTL) **152**
 Nike (NKE) **100**
 Nissan (NSANY) **54, 156**
 Nortel Networks (NT) **166**
 Novell (NOVL) **24**
 Numerica **137**

O

Onega **16**
 Oracle (ORCL) **24**
 Orbitz **14**

P

Pacificare Health Systems (PHS) **42**
 PepsiCo (PEP) **56**
 PG&E (PCG) **72**
 Philips (PHG) **62**
 Plantronics (PLT) **157**
 Premier Insurance Brokerage **42**
 Provident Financial (PVN) **19**
 Prudential Securities (PRU) **50**

Q

Quadrangle Group **120**
 Quaker Oats (PEP) **56**
 Quanta Computer **62**

R

RealNetworks (RNWK) **66**
 RightNow **40**
 Roke Manor Research **137**
 Roxio (ROXI) **66**
 Royal Dutch/Shell (RD) **72**

S

SalesForce **40**
 Sampo **62**
 Samsung **62, 66**
 Schnitzer Steel Industries (SCHN) **14**
 Sempra Energy (SRE) **72**
 Sharp (SHCAY) **62**
 Shepard International **118**
 Siebel Systems (SEBL) **40**
 Sony (SNE) **28, 66**
 Sound Foresight **147**
 Sprint (FON) **14**
 Standard & Poor's (MHP) **152, 158**
 Steefel Levitt & Weiss **46**
 Sun Microsystems (SUNW) **16**
 Symantec (SYMC) **40**

T

Teco Group **62**
 Thomson (TOC) **86**
 Ticketmaster (IACZ) **158**
 Time Warner (TWX) **120**
 TiVo **56**
 TNN **60**
 Toshiba (TOSBF) **28**
 Total Fina Elf (TOT) **158**
 Towers Perrin **42, 158**
 Toyota (TM) **54, 156**
 24/7 Real Media (T) **120**

U

UAL (UAL) **149**
 UBS (UBS) **54, 148**
 Uniden **157**
 United Financial Group **158**
 United Technologies **42**
 Universal (V) **66**
 U.S. Bancorp (USB) **150**

V

Verizon (VZ) **166**
 Vertis **120**
 Vivendi (V) **56**

W

Wachovia (WB) **158**
 Wal-Mart Stores (W) **66**
 Wellpoint Health Net (WLP) **42**
 Wells Fargo (WFC) **42**
 Wyndham International (WBR) **42**
 Wyse Technology **36**

X

Xerox (XRX) **106**

Y

Yukos **60**

Z

Zack's Investment Research **158**

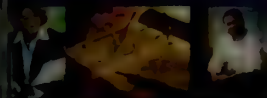
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A New Road Map For California

CALIFORNIANS HAVE BEEN throwing a populist fit for decades, and the recall of Governor Gray Davis and election of Arnold Schwarzenegger is the latest manifestation of that discontent.

Californians want low real estate taxes but keep passing initiatives for more spending on schools, health, and prisons. They want cheap illegal Mexican labor to work in hotels, farms, and construction but don't want to give them drivers' licenses. They want deregulated electricity but not for consumers. They want balanced budgets but impose impossible supermajority votes to pass them. They want more jobs but subject small companies to heavy legal and health mandates that make them uncompetitive. They want better political governance, but they vote for term limits that make legislators rely on special interests—and recall governors they just voted into office (page 36).

Californians want a lot of things, but not this: to make reasonable choices and pragmatic compromises to get things done. If Schwarzenegger is to succeed in digging California out of the hole it has dug for itself, then he must use his outsider, celebrity status to build a new political consensus to make California work again. If he fails, the flight of professionals and businesses from California to Idaho, Texas, Nevada, Oregon, Washington, and Utah could become a rout.

Unfortunately for California, a strong cyclical upturn in the

Californians want a lot but balk at reasonable choices and pragmatism

economy may soon alleviate the obvious symptoms of its deep structural problems. The three pillars of California's economy—high tech, global trade, and agriculture—are all showing signs of better health. The state's \$8 billion budget deficit will improve by mid-2004, even if the new governor does nothing.

But doing nothing would be a major mistake. California is becoming less and less

competitive. The state needs major

economic and political repair, and there is no consensus on what to do. One suggestion would be to check out Texas. Take electricity: Texas keeps its power local, stable, and half the price of California's. While it has deregulated to a degree, it never made California's blunders. Texas has also managed to keep its state workers' compensation system under control—while in California, premiums paid by businesses doubled last year. Recently, Governor Davis signed a bill increasing workers' compensation payouts by 100%, and premiums will rise again. Davis also added to the cost of doing business in his state by requiring companies with 20 employees or more

to provide health plans for all workers or pay a fee to a state-run health plan. This pummels California's 1.1 million small businesses that employ 80% of working-age residents. Many plan to move.

California will never be a low-cost state. It makes sense to concentrate on high-value-added services in tech, medicine, design, trade, advertising, and venture capital, allowing some production to migrate to low-cost states. But the new governor would be wise to roll back some of the expensive new mandates just passed. Good intentions do not necessarily make for good economic policy.

Californians should realize that their hothouse populism has made them virtually ungovernable. Voter initiatives mandate 70% of all state spending, limiting the negotiating room that politicians need to deal with budget crises. And requiring a two-thirds supermajority vote of the state legislature to pass a budget in effect paralyzes government. This has to change. At partisan war with itself, California is only itself to blame. Perhaps that's why Californians have turned to a larger-than-life figure—to make them do what they know they need to do.

Sharing the Health Burden

CONGRESS WILL soon debate whether to means-test the proposed Medicare drug benefit—and perhaps the entire Medicare program. The cost of the new benefit, \$400 billion over 10 years, highlights the enormous financial burden the 75 million baby boomers will soon place on government and society as they retire. With the budget deficit soaring into the trillions, the problem is acute. The debate is really about choices: preserving government medical benefits by having the wealthy pay more, or scaling back benefits to maintain them for all. It's a tough decision, but a realistic one.

It's a decision that Corporate America has already made. Many businesses are already charging higher-paid employees up to twice as much for their health care as lower-paid workers. And while most companies are trimming back on coverage, by and large they are choosing means testing of health services over drastic cutbacks of benefits (page 42).

Companies are applying a sliding-scale approach to premium payments, annual deductibles, and out-of-pocket maximum caps on medical expenses. That's fair, and it's better than the alternative—cutting benefits to all. There's denying the sticker shock spreading through Corporate America as employees open their company health plans in 2004. It is similar to the shock reverberating in Washington over Medicare. Choices have to be made. The better choice Congress is to ask those who can to pay more to help provide for everyone, including those who can't.

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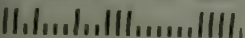
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THE CEO OF HIP HOP

Russell Simmons is the guru of urban style. Now he's helping established brands that seek an edgier marketing image.

BY SUSAN BERFIELD (P.90)

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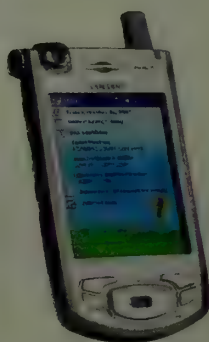
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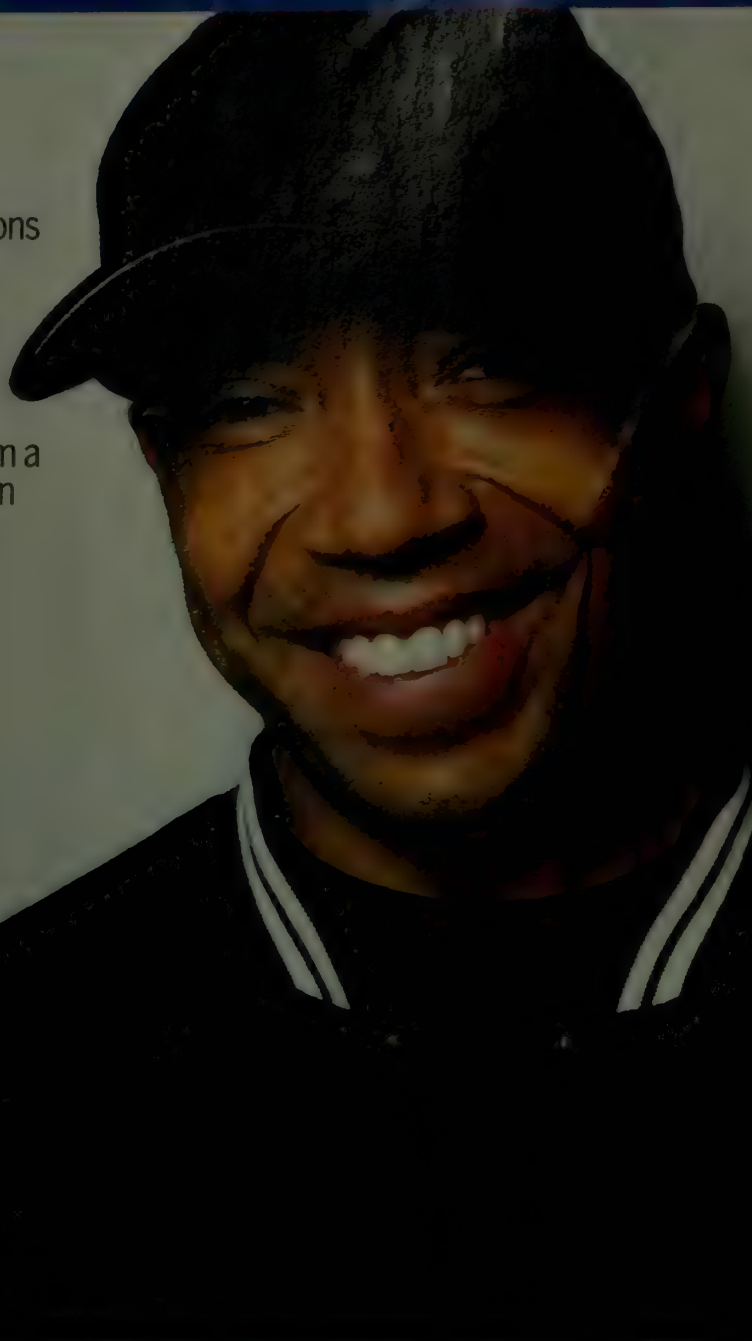
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90

PHAT CITY

Russell Simmons is an extreme entrepreneur. His hip-hop empire includes everything from a debit card to an energy drink



Cover Story

90 The CEO of Hip-Hop

There's hardly a major corporation that isn't trying to cash in on rap edgy authenticity. To reach this Hip-Hop Nat they turn to Russell Simmons, founder of the music label Def Jam and clothing maker Phat Fash. More than anyone, Simmons has helped bring an urban sensibility to popular culture.

News: Analysis & Commentary

40 Jobs: The Turning Point Is Here

It's not a boom—yet. But there are signs that hiring should start to climb

42 An Uptick in Tax Receipts

After three years of free fall, small gains are starting to appear

43 Commentary: Outsourcing

Foreign call centers do the job better and cheaper

44 Missing the Boat in Detroit

Ford and its rivals hang back on hybrids

45 GM: Who Needs Hybrids?

It's staking its future on fuel-cell cars

46 Choose Your Weapon, Arnold

Battling California's deficit will be tough

48 Look Out, iPod!

There will be competition by Christmas

49 Commentary: The NYSE

Mend, don't end, the specialist system

52 In Business This Week

International Business

56 Nestlé Is Slimming Down at Last

As the Swiss leader in world food sales sheds cost, its stock rebounds

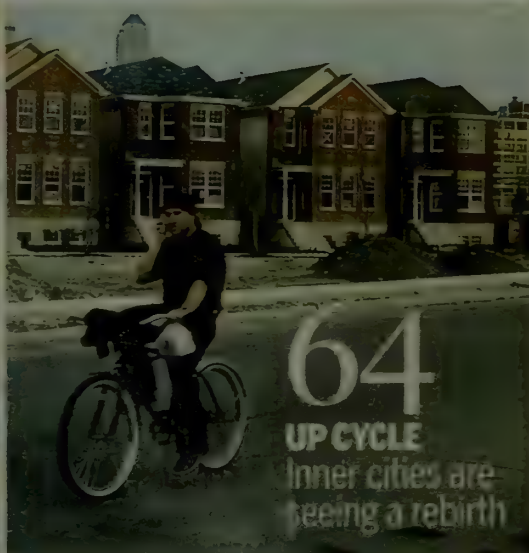
58 Commentary: France

The 35-hour week: *Quelle dommage*

44

LOW GEAR

Detroit hasn't caught the hybrid wave



64

UP CYCLE

Inner cities are peering a rebirth

ina: Reform
tao could emerge as a true force
political change
ernational Outlook
A U.N. deal still isn't going to pay
Is

Economic Analysis

onomic Viewpoint
New clues to the pay and
ship gender gap
Business Outlook
Every silver lining has a cloud
o: Waiting for the benefits of el
s rebound

Government

Washington Outlook
ie and Fannie have dodged tighter
ation—for now

Social Issues

in Inner-City Renaissance?
ation's ghettos have been making
omic strides, and the gains are
ning to erase decades of decline

Marketing

agra is Vulnerable
s Cialis lasts 36 hours—and a \$100
n ad blitz will spread the word

Science & Technology

Developments to Watch
gems for lasers; nanochips; a
er shot for the network
Attention Deficit: Not Just Kid Stuff
makers are starting to target adults
ADHD

Sports Biz

ll Football, All the Time
NFL is launching a TV channel

Entertainment

Cable Takes on the Video Store
video-on-demand's reach growing,
companies want movies faster



118

THE OIL LORD

With a daring deal in Russia, BP's John Browne is once again changing the face of the industry

Finance

- 100 Sarbanes-Oxley: Now the Bill**
Execs grumble about the high costs of complying with new financial controls
- 101 The Bean-Count Bonanza**
Who will profit from Sarbanes-Oxley
- 102 A New Luster for Metals**
Chinese demand is pushing up prices
- 104 Commentary: Lending**
An old law gives banks a raw deal

Information Technology

- 32 Wildstrom: Technology & You**
Microsoft Outlook 2003 not only looks better, it is better
- 106 A Rehab for Microsoft's Office**
The software upgrade will improve productivity for those working in group
- 108 Q&A: Bill Gates**
"Corporations feel like they have too many software vendors"
- 110 A Wireless World**
In a few years, mobile phones will dominate U.S. communications
- 116 The Phone Plan of the Future?**
"Home zones" for mobile users

The Corporation

- 118 The Oil Lord**
With a bold deal in Russia, BP's John Browne again is changing the industry

Personal Business

- 126 Home, Sweet Hotel**
A *BusinessWeek* survey of the best hotels and chains
- 130 Fine Dining? Try the Lobby**
Great eateries are popping up in hotels
- 132 Flat-Out Winners**
Airlines offer real beds in business class
- 132 Sweet Dreams in Coach**
The 1st Class Sleeper lets you stretch out
- 134 When Your Travel Agent is a Web Site**
The switch to online business bookings
- 136 Daytripping in the DMZ**
In between North and South Korea
- 138 Footnotes**
Halloween candy; fund performance; stock indexes; where to find fall color
- 140 The Barker Portfolio**
The clouds have already parted for Tyco
- 142 Marcial: Inside Wall Street**

Features

- 12 UpFront**
- 20 Readers Report**
- 22 Corrections & Clarifications**
- 26 Books:** McLean and Elkind: *The Smartest Guys in the Room*
Smith and Emswiller: *24 Days*
Collins: *America's Women*
- 144 Figures of the Week**
- 150 Index to Companies**
- 152 Editorials**

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Making the Case for Superpills

Drugmakers are hoping that pills packing a combination of medications for a variety of conditions will do a lot for patients—and even more to revitalize revenues

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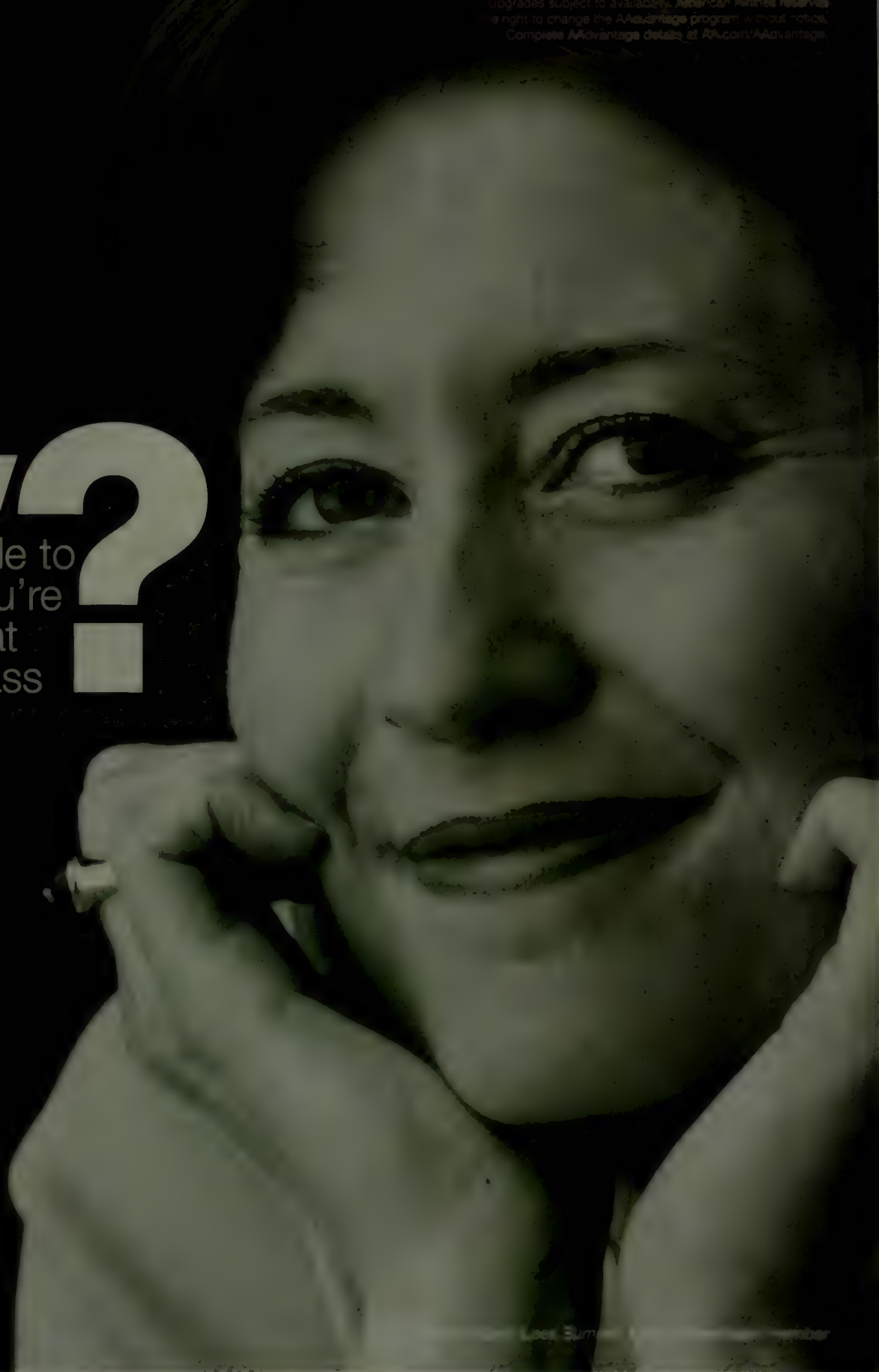
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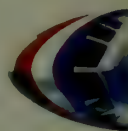
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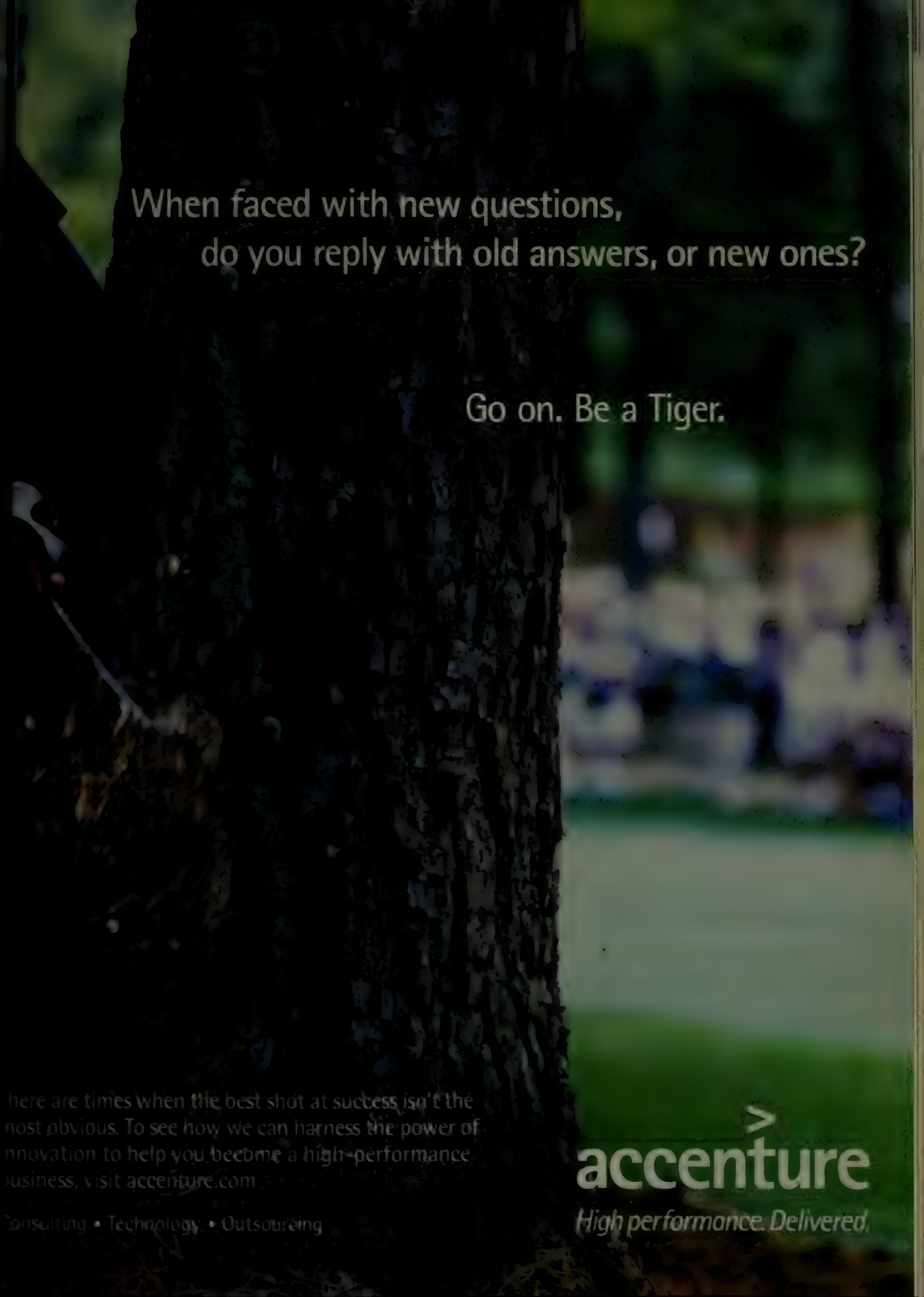
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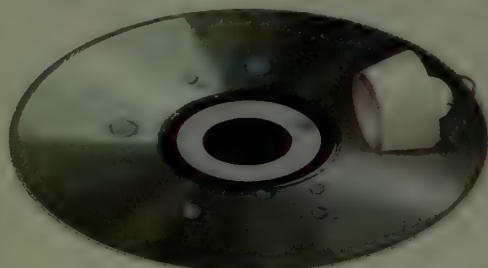
UP Front

"Of course I'm scared. The last place I would ever want to go is prison"

—Martha Stewart, in a 2002 interview with Barbara Walters

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SILICON CULTURE HEADING FOR THE EXITS AT HP



IS HEWLETT-PACKARD experiencing a brain drain in its storage business? In the past 15 months, at least six executives have bolted. That has some analysts worrying about HP's prospects. When HP listed the benefits of acquiring Compaq two years ago, it promised to shine in storage. HP's market share has held. But its \$3.6 billion in projected 2003 storage sales would be a 1% dip from last year, says **Merrill Lynch**.

HP's losses have been

EMC's gains. Five HP execs have jumped to the rival. The latest: On Oct. 8, Compaq storage vet Howard Elias joined EMC to manage its emerging businesses. Elias

ran storage for HP, but was in a broader management role recently. Another Compaq alum, Mark Lewis, joined EMC last year as chief technologist. And a

handful of storage engineers joined rival **Seagate Technology** last year. "I'm concerned about the ripple effect a year or two from now," says analyst Tony Prigmore of **Enterprise Storage Group**.

HP says the moves are largely due to melding two management teams—and the remaining team is seasoned. "They might not be as well-known, but they really get the job done," says Bob Schultz, HP's storage head. That's a must if HP is going to shine.

—Ben Elgin, with Faith Arner

THE BIG PICTURE

UNDER FIRE Percentage of fire chiefs who say the following are significant challenges to improving fire protection:

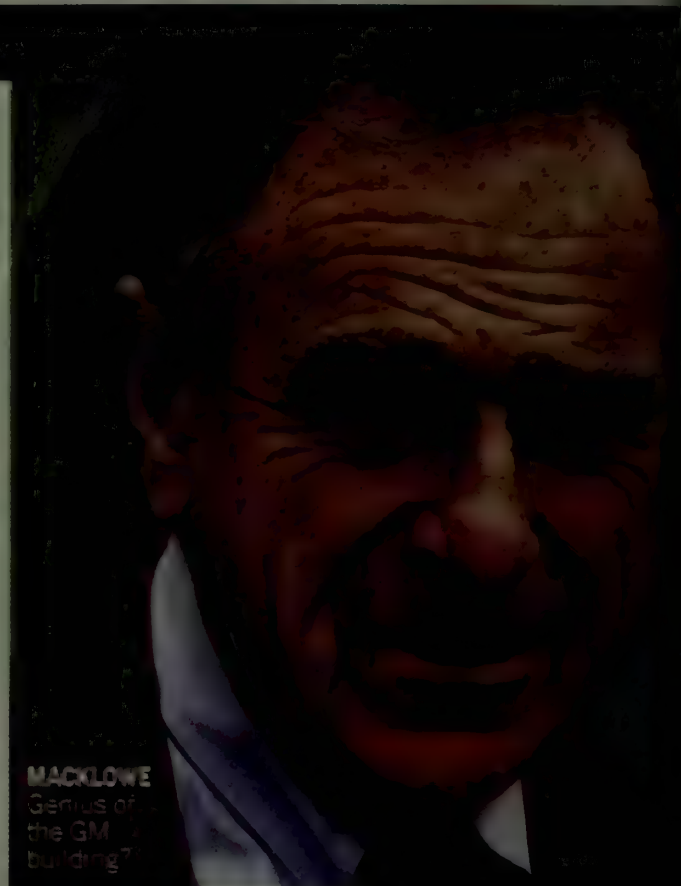
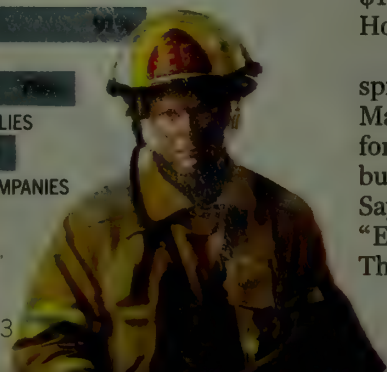
LACK OF ADEQUATE FUNDING

TROUBLE RECRUITING NEW FIREFIGHTERS

DIFFICULTY ACCESSING ADEQUATE WATER SUPPLIES

LACK OF COOPERATION FROM LOCAL WATER COMPANIES

Pool of 500 U.S. fire chiefs, marshals and commissioners, July 7-16, 2003. Data: Insurance Services Office, Opinion Research Corp.



MACKLOWE
Genius of
the GM
building?

ART OF THE DEAL

Leveraging A Landmark

IT SEEMS MANHATTAN landmarks can be had for less cash than you would think. The GM building sold for \$1.4 billion last month, or \$700 per square foot. That's about 46% more than other Midtown buildings. But the buyer, real estate tycoon Harold Macklowe, put up just \$100 million of his own cash—at most.

How did he do it? **Deutsche Bank** loaned \$1.15 billion. Macklowe also used more than \$200 million of a line of credit from **Soros Credit LP**, part of George Soros' empire. The deal is worth \$1.45 billion once closing expenses are added, says Robert Horowitz, a financial adviser to Macklowe.

The bet is risky. Deutsche Bank is parceling out its loan, spreading its exposure. With Manhattan real estate soft, Macklowe will need rates to stay low and rents to climb. He foresees continued low rates and has a plan to increase the building's income, says a spokesman. Others are skeptical. Says Douglas Shorenstein, CEO of landlord **Shorenstein Co.**: "Either [Macklowe's] a genius or he loses the building."

That's quite a wager.

—Nanette Byrnes



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HOTELS

VOTED BEST FREQUENT GUEST PROGRAM 4 YEARS IN A ROW — FREDDIE AWARDS 1999-2002

I-WAY PATROL

EUREKA! CHEAPER JOURNALS

NOBEL LAUREATE Dr. Harold Varmus is fed up with the high price of scientific journals. So Varmus, president of **Memorial Sloan-Kettering Cancer Center**, is leading a group that has started its own to compete with the likes of *Nature*, which can run \$920 a year. The difference: As of Oct. 13, a Web version of Varmus' *PLoS Biology* (for Public Library of Science) is free. And a yearly subscription for a print version is just \$150.



Two years ago, Varmus began pressuring the world's 28,000 scientific journals to make their content more accessible. "That just wasn't happening quickly enough," he says. So the group got a \$9 million grant and asked authors to pay \$1,500 for publishing costs. No paper will be rejected because of an author's inability to pay, Varmus says.

Publishers note that someone still has to pay. "There are costs," says Eric Swanson, head of scientific publishing at **John Wiley & Sons**. "It's never free." But it's getting closer.

—Catherine Arnst

THE LIST

States with the best and worst hospital rankings, determined by fatality rates for five common procedures:

BEST

- 1 North Dakota
- 2 Florida
- 3 Ohio
- 4 Michigan

WORST

- 47 Kansas
- 48 Tennessee
- 49 Arkansas
- 50 Alabama

Data: Health Grades Inc.



PRIVATE EYES

RESOLUTION By yearend, Space Imaging and DigitalGlobe may win approval to operate commercial satellites with cameras that can discern objects as small as 9 inches square. That's a lot sharper than what's now in orbit: anything under 24 inches square is too small to see. The new birds could go up in 2006. To help relieve the country's spy-sats, which have been hit by cost overruns and launch delays, the government has turned to private operators. The latest: On Sept. 30, DigitalGlobe won a \$500 million deal from the Pentagon and Homeland Security Dept. DoD worries about terrorists using the birds. The feds will probably restrict access. —Otis Po

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FACE TIME

WENDY THOMAS



DADDY'S GIRL GETS BACK TO BURGERS

Wendy's back. The fast-food chain's namesake has joined with her brother and three sisters to buy 15 Wendy's restaurants near Columbus, Ohio, where dad **Dave Thomas** opened his first hamburger joint in 1969.

Wendy Thomas has been a franchisee before, but she sold her five Dallas outlets in 1999. After her father died in 2002, she says, the children wanted to do something as a family. "We just felt this big hole in our heart. And we thought of Wendy's because it was dad." The terms of their Oct. 2 deal were not disclosed, but franchises typically sell for \$500,000 or more, plus land.

Wendy—the nickname she prefers to her real name, Melinda Lou—says she really did look like the caricature when she was little: red hair in pigtails, freckles, buck teeth. That and her catchy moniker were why her father named the company after her. Today, she says she takes her four kids to Wendy's every day—just like dad used to do.

—Michael Arndt

AUTOS

YOUR MOUSE KNOWS WHERE YOUR CAR IS

TEENAGERS ARE going to hate this, but now there's a service that lets you keep track of the family car after you've loaned your kids the keys. Installed under the dash, a gizmo called Networkcar uses the global positioning system to report the location of the vehicle every two minutes over a wireless network. To find out where the car is, you log on to a Web site to see the automobile pinpointed on a map—with a street address.

Networkcar is sold by about 100 car dealers, and it's catching on fast. It costs \$995, including the first year of service. After that, it's \$9 a month. And it does more than keep tabs on your kids. Networkcar comes with roadside assistance—up to four calls a year to fix a flat—and a guarantee from manufacturer **Reynolds and Reynolds** that if your car is



stolen, police will recover it within 24 hours. Unlike LoJack, which is used only for recovering stolen vehicles and isn't turned on until the police are notified, Networkcar is always on when the car is running. When it's parked, the Web page shows the last location reported, essentially where the car is parked.

Because the device plugs into the same diagnostic port that mechanics use to hook your car up to the shop com-

puter, it also constantly monitors the car's performance. For example, the warning light on the dash goes on, it sends you (and your dealer) an e-mail saying what's wrong. It also will notify you when the oil needs to be changed. A bonus for Californians, thanks to a deal with that state: Networkcar automatically checks your emissions, so you can skip that pesky every-other-year smog check. —Larry Armstrong

FINANCE

WAKING UP FROM THE AMERICAN DREAM

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26%

if the borrower gets divorced from his or her spouse



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for each additional household member after the first two

THE STAT

14

The percentage drop in average total compensation of chief financial officers last year. Their pay fell to \$1.3 million, from \$1.61 million in 2001.

Data: The Todd Organization

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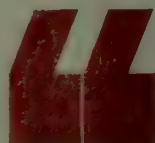
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I own 10 shares of Wal-Mart and plan to buy more. That's called free enterprise, folks, and it's what made America great!"

—Martin Mayberry
Bartlesville, Okla.



WAL-MART: THE GOOD, THE BAD, AND THE UGLY

WAL-MART STORES INC. IS FAR from a zero-sum game ("Is Wal-Mart too powerful?" Cover Story, Oct. 6). A lot of money flows into each Wal-Mart, but very little trickles back out. The communities, large and small, that Wal-Mart invades were built by many years of investment through taxes and private investments, so residents could have infrastructure for a community that is a good place to live.

Once upon a time, there were small stores with small owners who spent most of their profits in their own local community. With Wal-Mart, those profits are now shipped off to headquarters and invested in faraway places. Local communities may be getting the zero-sum gain of sales tax (when they didn't cut a bad deal for the giant box to land in their town), but the great bulk of the sales revenue never touches Main Street again.

—Jim Reilly
Beverly Hills

I FIND IT UNSETTLING that, in the article on Wal-Mart, the company is labeled a right-wing, conservative, small-town cultural gatekeeper. If Wal-Mart is, in fact,

the largest company of its kind, how did it get that way? By pushing some posed moral agenda? How about thumping Bibles? No. Of course not. It got that way by out-competing rivals, not by beating them because it had what the competitors want at the price that allows it to keep more of their money than any other guy does. Simple.

—Keith B.
Wailuku, Hawaii

THIS IS THE WAY I look at it: We don't believe in free enterprise in America. We can't have it both ways. I own shares of Wal-Mart and plan to buy more. That's called free enterprise, folks, and it's what made America great!

—Martin Mayberry
Bartlesville, Okla.

IN MY 20-YEAR CAREER in the packaged-goods industry, I've had the opportunity to work with dozens of retailers, including Wal-Mart. Very few—and I count them on one hand—are as concerned with value for their customers as Wal-Mart. Every meeting, every conversation, every issue discussed comes down to what can we (the supplier and I)

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Readers Report

CORRECTIONS & CLARIFICATIONS

Sean Moran, chief financial officer of Sontra Medical, says Sontra's SonoPrep product will be marketed in 2004 for topical lidocaine delivery, not for glucose testing ("Sontra Medical looks healthier with Bayer," *Inside Wall Street*, Oct. 13). The glucose-testing product will be marketed in late 2006 or early 2007.

The Ammon twins will inherit approximately \$15 million, according to Generosa Ammon Pelosi's July, 2003, will—not \$25 million, as reported in "A murder mystery, a money mess" (*Finance*, Oct. 20).

Mart) do to provide a better value to the customers. In my opinion, that's what made them successful.

—Brahim Zabeli
Shorewood, Minn.

THOSE OF US WHO struggle to lead this country's smallest businesses have felt the wrath of Wal-Mart's efforts to cut costs out of the procurement process. My family's business is in a completely unrelated industry (aerospace products), but we have been affected dramatically because the Wal-Mart "playbook" is read by my customers and their customers, too. It's going to be interesting when the Wal-Mart story is revisited in 5, 10, and 20 years because it looks as if it still has room to grow.

—Scott Livingston
East Hartford, Conn.

I BUY GOODS THAT GO to Wal-Mart for my living, and I travel to China once a month to find these products. The figure given for material purchased from China (by Wal-Mart) is only a low-end estimate, at 15%, and is likely much higher. That's because when they aren't "buying direct," they are forcing American manufacturers (like mine) to magically transform into desperate "Asian distributors."

It should be pointed out that Asia, and therefore all of us, owe our 15% Wal-Mart savings to the backbreaking labor of 15-year-old girls working for \$3 to \$4 a day. At the end of the day, further savings will only come from squeezing poor people in China and in America.

—Mike Phillips
Chicago

I USED TO LOVE SHOPPING at Wal-Mart when Sam Walton was alive because the merchandise was mostly USA-made, people were important (both workers

and customers), and there seemed to be a connection with the community in which the store was located. Now the store itself is this big monster that has no connection with anyone.

—Susan Walter
Colorado Springs

I GET SAVINGS FOR my family at Wal-Mart and will happily give up my ability to buy a copy of *Maxim* for that, especially since I've never bought one.

—Ranjit Prabhu
South Orange, N.J.

WHILE 82% OF US may have purchased something at Wal-Mart last year, millions willingly pay more to purchase higher-quality products in stores that are smaller, cleaner, less cluttered, and more convenient than Wal-Mart.

—Christine P. Schaller
Penfield, N.Y.

I HAVE LIVED IN small towns and understand firsthand the importance of having a Wal-Mart located close by. I now live in a large city and am eagerly

awaiting the opening of a new Wal-Mart supercenter three miles from my home so that I can save money on groceries. Wal-Mart is cheap, close by, and typically has the everyday items I'm looking for. This is an excellent formula for winning my business.

—Kevin Ingolf
Woodstock

YOUR ATTEMPT AT gloom and doom missed the mark by an Arkansas mile.

—Brian O.
Highlands Ranch, Colo.

FOR A COMPANY that pinches pennies until they squeak, it smacks of corporate cost oversight or a corporate director or possibly both—to treat employees as if they were so much disposable product. Does anyone at Wal-Mart really understand what [employee turnover] means at the bottom line?

—Frank H.
Alpharetta, Ga.

A BAD CONSUMER CONFIDENCE number was released today (Sept. 30), causing

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stock market to tumble. Each week, Wal-Mart gives us real-time numbers from their same-store sales report. This report (Sept. 29) was at the high end of their forecast. The markets should take this number and ignore the other economic reports. As Wal-Mart goes, so goes the economy.

—Neil Gambell
Kearny, Ariz.

ISN'T WAL-MART opening stores in new areas? If it is O.K. for the rest of the country to have a Wal-Mart economy, then it should be O.K. for China as well. When empty containers headed back to America are filled with goods made in China and other countries, it will be a Wal-Mart-World."

—Stan Blankenship
Wichita

IN AN ABSENCE of 30 years, I have managed to live in the Midwest, and after coming through the Main Streets of small towns, I can make the following observation: When Wal-Mart comes to town, they get to sell the new

stuff. The only thing left for Main Street to sell is—antiques.

—John Gochenouer
Marshall, Minn.

JUDGING THE FAIRNESS OF WAL-MART'S PRACTICES

IN "THE HIGH COST OF LOW PRICES" (Editorial, Oct. 6), you objurgate Wal-Mart for its business practices. But the examples you cite all seem to be legitimate instances of dealing by mutual consent. When entry-level workers come to Wal-Mart, they freely choose to accept a low wage because on balance they see it as a good deal. Competing "mom-and-pop shops" go out of business—as they should—if they fail to draw enough customers. Manufacturers sell to Wal-Mart because it is advantageous to do so.

Finally, to the extent that Wal-Mart's "Southern-style cultural conservatism" is distasteful to potential customers, there are opportunities for other retailers to capitalize on this and use a different cultural style to market goods.

—Barry A. Liebling
New York

YOUR EDITORIAL NOTES with approval that Wal-Mart has agreed not to sell guns in its first inner-city location in Los Angeles. Did it conduct scientific survey research to reach that decision? The answer, of course, is no. But what if it had and found that a majority did in fact wish to have the option of buying a gun there—what then?

Could it be that a little cultural gate-keeping meets with your approval?

—David Light
Maynard, Mass.

WHY WINSTON-SALEM IS STILL SMOKIN'

AS MAYOR OF WINSTON-SALEM, I must respond to the picture of layoffs at R.J. Reynolds Tobacco Co. painted in "Blues for a company town" (News: Analysis & Commentary, Oct. 6). Winston-Salem began diversifying its economy in the late 1980s and has made solid progress in that regard.

The best proof of this is that each of the major credit-rating firms rates the City of Winston-Salem and the County of Forsyth as AAA. Only a few cities and counties throughout the country enjoy this level of credit rating. Obviously, we have been able to demonstrate satisfactorily to these objective organizations that our economy is healthy and appropriately diversified.

The workforce in our county is in excess of 160,000. A loss of 1,600 jobs, while substantial, is not overwhelming.

—Allen Joines, Mayor
Winston-Salem, N.C.

WEB SEARCHES: THE MAD AVE. OF CYBERSPACE?

PAID INCLUSION is no different from product placement in supermarket aisles, where companies pay—either in the form of margin or hard dollars—to have their product placed exactly where they want it in the shopping aisle ("Web searches: The fix is in," Information Technology, Oct. 6). No one is berating the supermarket chains for their equivalent of paid inclusion, and even less consumer education has been done in the supermarket world than in online search.

—Chris Zaharias
Menlo Park, Calif.

PAID INCLUSION is only part of the problem. Any site selling old jalopies can hire specialists called keyword optimizers. For a price, they can dress up the site to make it look downright alluring to the robot crawlers—which now "think" they've come across a page selling Cadillacs. This

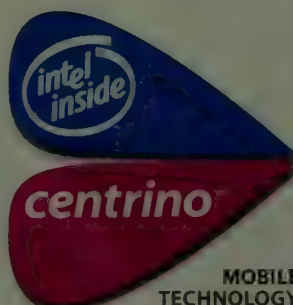
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may be another reason why, as stated in the article, Web surfers are starting to "dismiss Internet search as nothing but a pile of ads."

—Joe Chiffriller
New York

WITHOUT COMMENTING on the merits or otherwise of paid inclusions for Internet searches, the notion put forward by the proponents of this concept that their search results are nevertheless displayed in order of relevance is laughable. If this were true, then by definition the incentive for companies to pay for such inclusion would be eliminated since their relevance to the search query, and hence their relative ranking to other Web pages, must remain the same. Since most profit-seeking businesses are not in the habit of paying for a service from which they derive no benefit, one can't help feeling that certain proponents of paid inclusions are being somewhat economical with the truth here.

—Nick Piquito
Johannesburg

FROM FRANCE: PROUDLY AN 'ANTI-BUSH PRO-AMERICAN'

JOHN ROSSANT'S COMMENTARY, "The real war is France vs. France" (International Business, Oct. 6), misses one essential point: One can be both "pro-American" and "anti-Bush Administration." I have been a subscriber to *BusinessWeek* for 24 years, both in France and in the U.S., where I studied and worked as a professional for 10 years. I have always deeply admired this beautiful nation of yours, which is, without any doubt, the best democracy in the world.

The current Bush Administration is, however, doing a disservice to the nation with the Iraq invasion, setting back the country in the worst years of worldwide anti-Americanism since the Vietnam war. Thus, you have a third category of French people, besides the "anti-Americans" and

the "anti-anti-Americans": the "Bush pro-Americans" to whom I proudly belong. I am sure you'll catch the nuance here, a little bit like being "anti-Saddam pro-Iraqis."

—Christophe J. Ni

THE RIFT BETWEEN France and the U.S. is more the clash of American optimism and old European pessimism. Very few Americans are eager to give bold ideas a chance, old Europeans, always fearing the worst, are quick to beat them down. Giving Iraq and the Middle East a shot at freedom and democracy is just one example. Optimism vs. pessimism is playing out today in a host of other issues, such as how to best govern a free population, and therefore subjecting citizens to heavy regulation.

The U.S., to the contrary, views a shackled population as a source of economic dynamism and prosperity, though we ought not be foolishly optimistic, the dangers of pessimism are real, as it leads to inaction and missed opportunities. Worse, it is often exploited to frighten populations into accepting taxation, regulation, and nanny government which without coincidence leads precisely to the economic problems dogging Old Europe today.

—Pierre Gosse
Quakenbrück, Germany

VCS ARE SHOOTING THEMSELVES IN THE FOOT

IF VENTURE CAPITALISTS are doing what you say they are doing, they are shooting themselves up for failure—if our recent research into first movers and followers in 27 e-business technology markets is any guide ("All cashed up, no place to go," Finance, Sept. 29). "first new thing," as one venture capitalist was quoted as saying, is not when you expect future market leadership.



Enron Under Two Microscope

THE SMARTEST GUYS IN THE ROOM The Amazing Rise and Scandalous Fall of Enron

By Bethany McLean and Peter Elkind; Portfolio; 435pp; \$26.95

24 DAYS How Two Wall Street Journal Reporters Uncovered the Lies that Destroyed Faith in Corporate America

By Rebecca Smith and John R. Emshwiller; HarperBusiness; 400pp; \$25.95

In the two years since Enron Corp.'s implosion, several authors have tried to dissect the company's complex financial maneuvers and corrupt culture. Now, some of business journalism's heavy hitters have joined the fray with their own books on the scandal—and the results are uneven.

Two teams of authors, Bethany McLean and Peter Elkind of *Fortune* and Rebecca Smith and John R. Emshwiller of *The Wall Street Journal*, have taken very different approaches to the now-familiar tale. In *The Smartest Guys in the Room*, McLean and Elkind build their story around the complex cast of characters who destroyed Enron. True, that has been done in other Enron books, but not with the clarity and voluminous detail that make this the best book about the Enron debacle to date. In *24 Days*, Smith and Emshwiller construct the story around themselves and their dogged efforts to uncover the secretive partnerships run by Enron Chief Financial Officer Andrew S. Fastow. The result is a sometimes awkwardly self-conscious look at the way journalists work, which will likely prove more interesting to other reporters and public-relations spinmeisters than to the general public.

Based on hundreds of interviews and fresh details from personal calendars, performance reviews, e-mails, and other documents, McLean and Elkind masterfully weave together the many strands of the Enron story. They shine in their characterizations of Enron's often incompetent executives and in their understanding of the ruthless internal politics that contributed to the company's many business and personnel mistakes. They provide keen insight into the company's powerful traders and how their brutal culture infected the rest of the company. "Though [Chief Executive Officer Jeffrey K.] Skilling was their boss, he seemed intimidated by them. They were like a powerful high school clique that terrorizes even the principal," the authors write. Yet their sprawling narrative should make it clear once and for all that Enron's demise can't be blamed solely on Fastow and his small band of greedy finance executives. The authors show how, time and time again, Skilling and Chairman Kenneth L. Lay refused to "rein in the excesses."

The authors are equally adept at explaining Enron's

accounting sleight-of-hand, including the "prepays" that obscure the company's true cash flow and the Byzantine "special purpose entities" created by Fastow and his cronies to mask Enron's deteriorating finances. The long-running investigations by the Justice Dept., the bankruptcy court examiner, and others have also produced a raft of data that authors skillfully sort and summarize to dramatic effect. If there's a weakness in the book, it's a heavy reliance on unnamed sources—the authors say that was necessary because of the fear many had about the ongoing probes and lawsuits and the lack of attribution at times for information that does seem to have come from the reporters' own notebooks.

that's a small complaint for such a successful effort.

In *24 Days*, Smith and Emshwiller, who won the 2001 Gerald Loeb Award for their coverage, break little new ground in exposing Enron's deceptions. Instead, readers get a microscopic view of the reporters' work.

The 24 days of the title represent the time that elapsed between Enron's disastrous quarterly loss, announced on

Oct. 16, 2001, and the Nov. 8 restatement of its financial results after a string of scathing *Journal* stories. But the authors really began their tale in August, 2001, with the resignation of CEO Skilling after about six months on the job. That sets off alarm bells and puts energy reporter Smith and her Los Angeles colleague Emshwiller on the trail.

Like most journalists (not to mention analysts and credit-rating agencies) covering Enron, Smith is initially clueless about the depth of its problems, even after

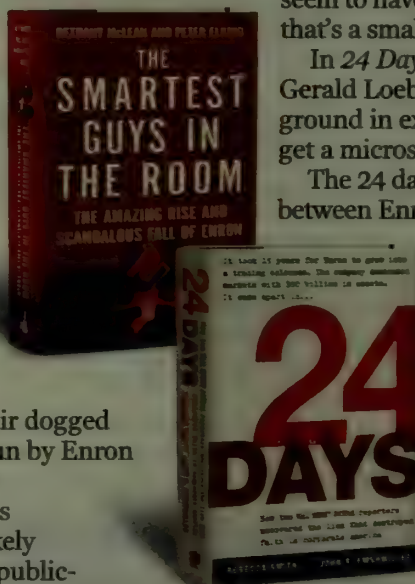
two years of following the company. It is white-collar-crime reporter Emshwiller who first notices a peculiar reference in Enron's financial filings to an unnamed "senior officer" running partnerships that do business with Enron. But only as a result of persistent digging assisted by savvy tipsters who offer inside documents—do the reporters ultimately learn the

A detailed study, and a "how they got that story"

details of Fastow's self-dealing.

While the story moves along briskly, the authors seem uncomfortable writing about themselves, and the result is some clunky, third-person prose. Still, the inside tidbits, from reporters' turf wars to editors' badgering, will strike other journalists as amusingly familiar. For Enron junkies and business reporters, this is on the must-read list, too. ■

—By Wendy Zell



CLOUD THE ISSUE

OR CLEAR THE AIR?

The issue of global warming has given rise to heated debate. Is the burning of fossil fuels and increased concentration of carbon dioxide in the air a serious threat or just a lot of hot air? Shell believes that action needs to be taken now, both

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Hard to Enjoy Being a Girl

CA'S WOMEN 400 Years of Dolls, Drudges, Helpmates, and Heroines
Gail Collins; Morrow; 556pp; \$27.95

Several years ago, I picked up a household guide for women that had been written in the 1880s by a physician. There, among hints for baking a vinegar pie and advice on curing cancer, were instructions on sexual behavior. Ironically enough, it said those who wanted children must endure years of abstinence: Upon getting pregnant, women were to cease having sex until the child reached age 2. Then one morning, after a good night's sleep and a nutritious breakfast, they were to

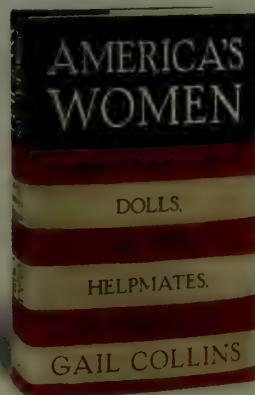
intercourse at precisely noon, when human creative powers are at a peak. They would immediately get pregnant, the doctor said, and then endure another 2½-year dry spell.

Historians expected women to embrace the idea of triennial abstinence, but women were as too delicate for such a physical intimacy.

No matter that they were also expected to be household drudges—washing children, laundry tubs, and cast-iron cooking pots.

Throughout American history, women have been required to adopt contradictory roles, writes *New York Times* editorial page editor Gail Collins in *America's Women: 400 Years of Dolls, Drudges, Helpmates, and Heroines*, an encyclopedic narrative of a 400-year history of progress. Southern girls were expected to be helpless before marriage and plantation managers after. Pioneer women wore bonnets and gloves to keep their skin white while plowing the fields. White women were scorned for taking jobs, while blacks were vilified if they didn't.

America's Women is a one-stop history of the lives and times of the women and sex in the U.S. Although it



contains little original material—and many of its stories will be familiar to students of women's history—there's a wealth of information. Moreover, despite the book's heft, Collins' accessible, entertaining style makes it a brisk, enjoyable read.

One major theme in women's experience is “leaving home—crossing oceans and continents, or getting jobs and living on their own,” writes Collins. Among the first group of white women to ship out from England for America, in 1587, was Eleanor Dare. She arrived in time to give birth to the first white child, Virginia, named for the Virgin Queen. Shortly thereafter, mother and daughter, along with the other 100-odd settlers of Roanoke Island, mysteriously disappeared.

The death rate among all early settlers was astonishingly high. But women had the added burden of childbearing—an average of seven children per female in early New England, where 20% of women died in childbirth. Spousal abuse was not uncommon. Occasionally, there were startling occurrences: One starving husband murdered his wife and “fedd upon...her partes.” Little wonder that many women were reluctant to migrate to the colonies, just as some of their 19th

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While changing planes in Chicago on the way to making a speech in Denver, my phone rang. Rumors were flying. Our biggest holding was having some major credit problems. I had 10 minutes to decide what to do.

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ry descendants resisted moving
ard.
men were expected to perform
hold duties under the most trying
stances, and of course, freedom
portunity were largely limited to
Many readers will recall Abigail
s' plea to her husband John to
ember the ladies" in his work at the
mental Congress. Less well-known is
s' reply: "As to your extraordinary
of laws, I cannot but laugh."

e women in the early Republic
lly had more independence than did
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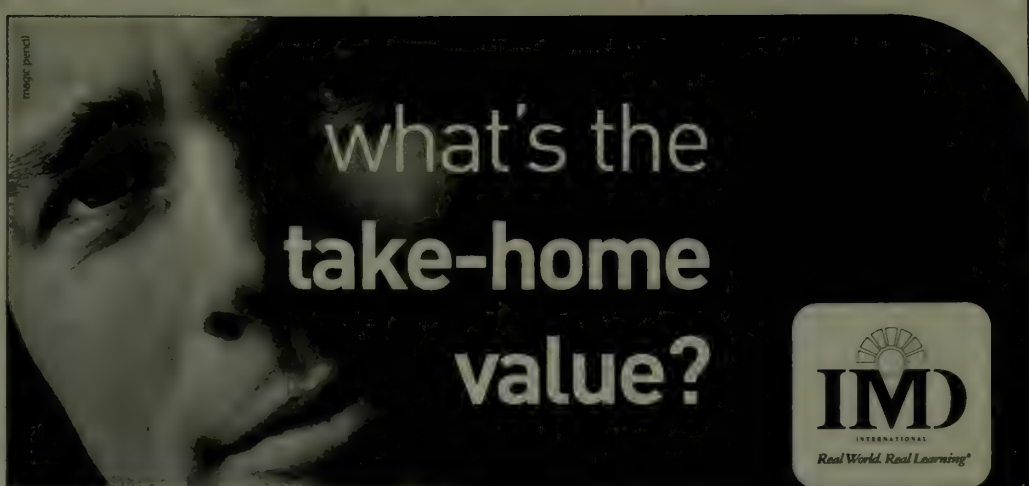
a male guardian
had been
appointed to make
decisions for the
children. In North
Carolina, only a
virgin could
charge a man with
rape. And about
1800, a New York
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acquitted a
wealthy lawyer of
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use the girl should have known that
one of his position couldn't possibly
terested in her for anything but sex.
ollins shows that female roles
ged according to what men wanted.
ng the Great Depression, married
en who worked were seen as a
ace to society, since they were taking
away from men. Just a few years
during World War II, the
rnmnt pleaded with women to take
se work—and blamed war losses on
e who shirked. Then, after the war,
en were fired so male veterans could
their jobs. The postwar economy
ed females to act as consumers.
hile progress has come in fits and
s, "it's impossible, still, not to cheer"
undeniable advances, writes Collins.
e year 2000, women were awarded
of all college degrees and accounted
lmost half the students in law and
ical schools. Women are in the
utive suite, on the Supreme Court,
in space—but they still might be
ected to know how to bake a pie. ■

—By Sandra Dallas

BusinessWeek's first female bureau
of, beginning in 1969, Dallas now writes
novels. Her latest is *The Chili Queen*.

image pencil



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BY STEPHEN H. WILDSTROM

A Brighter Outlook For E-mailers

Microsoft Outlook probably drives more people crazy than any other software application. For tens of millions of people who use Outlook for access to corporate e-mail systems, and for tens of millions more who use it for Internet mail and to manage their contacts and calendars, Outlook is likely their single most important program.

Now there's good news for anyone who has struggled with Outlook's complexities. Most of the changes in Microsoft Office 2003 (page 114), available at retailers on Oct. 21, are of interest primarily to corporate technology managers. But while Word, Excel, and PowerPoint offer little new to most users, Outlook gets both a face-lift and an under-the-hood overhaul that makes it easier to use, especially for people who read corporate mail from home or on the road.

The changes in appearance are striking. The screen is divided into three vertical panes. The "Outlook Today" icons and the jumble of folders are replaced by a pane whose contents change as you switch among mail, calendar, and contact views. In the mail view, the middle pane lists your messages and, for the first time, you can group them by topic sorted by date rather than alphabetically. Finally, the right pane contains the body of the selected message.

LITTLE THINGS MEAN A LOT in determining ease of use, and this redesign makes Outlook less frustrating. But many important revisions are less obvious. Links to content on the Web no longer open automatically, so if you want to see the pictures, racy or otherwise, you'll have to ask that they be downloaded. This makes it harder for spammers to plant "Web bugs" that report back on your online activities.

The biggest change affects those who use Outlook with Microsoft Exchange, the most widely used corporate mail system. Inefficient use of the network in earlier versions of Outlook made the program painful, if not impossible, to use on slow dial-up connections and tough even on the relatively

high-speed links used by small branch offices. Outlook 2003 does most of its work on a local copy of your mailbox, speeding up work dramatically. This makes the new Outlook a must-have, especially for mobile workers.

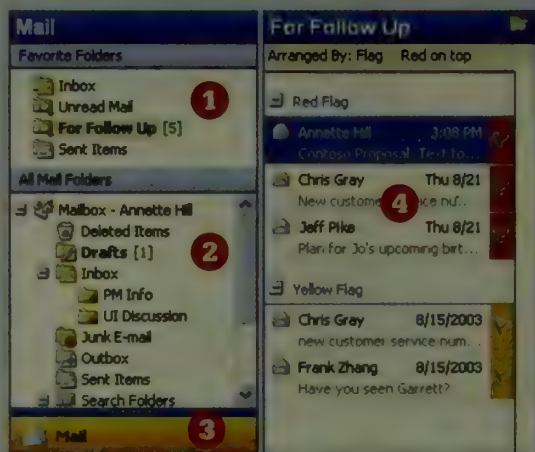
One place you'll see the difference is in faster searches of messages. You can also set up "search folders" in which the contents of frequently used searches are kept updated. (Those using Internet mail rather than Exchange may want to try Bloomba, a mail program from S Labs that I'll review in a coming column.)

The rest of Office 2003 will appeal mainly to enterprises that want to take advantage of a technology called extensible markup language or XML. This, for example, allows information entered in a form created in Word to be captured easily in a database. And for the first time, Microsoft is offering an attractive deal for families. A new Teacher and Student Edition, including Word, Excel, PowerPoint, and Outlook, costs \$149 and is licensed for use on up to three computers. Other editions cost \$399 to \$499, or \$299 to \$329 as upgrades. Outlook alone costs \$109.

Most ordinary users will have a hard time seeing the value of the new Outlook. The idea of what to do with XML or some other advanced features that only work with a Windows 2003 Server. But the appeal of Outlook 2003 is immediate and strong. If you're a user of Outlook and Exchange, this is an upgrade worth the price.

E-mail: tech&you@businessweek.com

Sleek, New Face



1. MAIL FAVORITES You choose folders to list for easy access

2. FOLDER LIST All of your mail folders appear here, listed alphabetically

3. SELECTION BUTTONS Choose major Outlook functions, such as Mail, Contacts and Calendar

4. MESSAGE LIST The subject and sender of messages in the selected folder appear here

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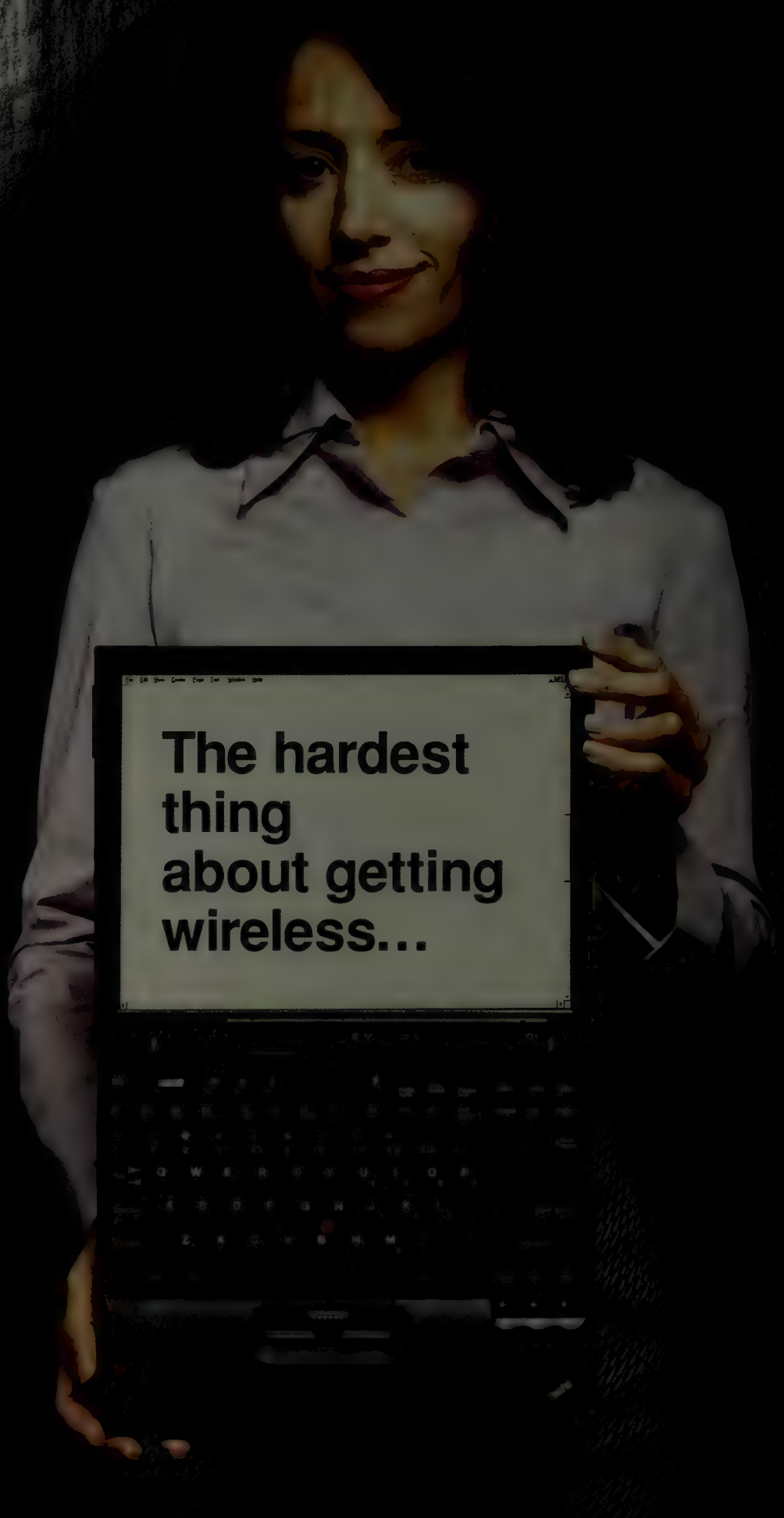


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A woman with dark hair, wearing a light-colored button-down shirt, is holding a laptop. The laptop screen displays the text "The hardest thing about getting wireless...". The background is dark and textured.

**The hardest
thing
about getting
wireless...**



Analyst viewpoint. Source: TDR Research. © 2003 Intel Corporation. Intel, Intel Inside, Intel Inside logo, Intel Centrino, Intel Centrino logo, and the Intel Inside logo are trademarks or registered trademarks of Intel Corporation or its subsidiaries in the United States and other countries. All other company names are trademarks of their respective companies. © 2003 IBM Corp. All rights reserved.

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is getting
wireless.

IBM
POWER TO BUSINESS



BY LAURA D'ANDREA TYSON

New Clues to the Pay And Leadership Gap

Women continue to climb the corporate ladder. According to Catalyst, a nonprofit research and advisory organization working to advance women in business, women now hold twice as many senior management positions in large American companies as they did in 1995. Yet despite such progress, women occupy only about 16% of such positions and 13% of

board of director seats in U.S. corporations—and the percentages are even lower in the rest of the world. Moreover, top leadership of large public companies remains almost universally male. In the U.S., only six of the CEOs of the Fortune 500 are female. According to Graef Crystal, a corporate-pay expert, women occupy only about 5% of the top five slots and 2% of the chief executive slots in U.S. public companies with net sales above \$5 billion.

The good news, says Crystal, is that those women who do have the top job are paid every bit as generously as their male counterparts. Both business size and rank within the top five leadership slots affect an individual's compensation level, but gender does not. Crystal finds no evidence that top female execs suffer from pay discrimination in large American companies. The problem for women is breaking through the glass ceiling, not getting equal compensation once they do so. So a nagging question remains: Why do so few women make it to the top corporate echelons?

As an economist and business-school dean, I have asked myself this question many times. Recently, I have discovered fascinating new evidence that suggests some answers. First, women and men appear to have different attitudes toward competition. Scholars led by Uri Gneezy at the University of Chicago Graduate School of Business have found that competition enhances male performance but does not affect female performance. Men complete more tasks when payment goes only to the individual who completes the most tasks than when payment depends simply on the number of tasks completed. Women's performance is the same in both. Boys run faster when paired against other boys and faster still when running against girls than when running alone. Girls run at about the same pace in all three circumstances. And despite modern companies' official embrace of teamwork, getting to the top remains a highly competitive process that rewards individual performance. So men do better.

Second, both experimental and survey research show that men are much more likely than women to negotiate for pay, promotions, and recognition in the business world. In her compelling new book *Women Don't Ask*, professor Linda Babcock of Carnegie Mellon University reports that only 7% of female graduates from master's degree programs at

Carnegie negotiate for a higher salary than the one initially offered by a potential employer, while 57% of male graduates do. And negotiating pays off: The starting salaries for male graduates are more than 7% higher than those for females. Babcock finds that different negotiating styles explains much of the gap in women's starting pay, and this gap explains a large part of the persistent pay differential between men and women throughout their careers.

Higher pay is also assumed to mean better performance. Individuals with identical experience and performance records but stronger compensation histories are more likely to receive positive work evaluations and be offered more promotion opportunities. And since women are much more

Only 7% of female grads negotiate a higher first offer, vs. 57% of men

likely than men to believe that working hard and doing a good job will earn them advancement, they are much less likely than men to negotiate for such promotions—and thus much less likely to receive them. The reluctance to negotiate may explain why women often find it hard to get the pivotal assignments that lead to the corporate boardroom.

In addition, Catalyst reports that a third of professional women not yet in the most senior leadership positions do not want them. Why

Because to get to the top, they often have to give up having children or spouses. According to the National Parenting Assn., 42% of female corporate execs aged 41-55 and 49% of women earning more than \$100,000 per year are childless.

This may change. Women now get more than half of all bachelor's degrees and master's degrees, half of all law degrees, and about a third of all MBA degrees at U.S. universities. The number of women reaching leadership jobs just below CEO level is rising fast. As women gain influence they are likely to champion changes that ease the trade-offs between work and family. As a business school dean, I am optimistic about the future of women in business. ■

Laura D'Andrea Tyson is dean of London Business School.

JAMES C. COOPER & KATHLEEN MADIGAN

A Silver Lining's Menacing Cloud

Higher demand will lead to a rising trade deficit—even with a lower dollar

U.S. ECONOMY “Think globally.” That has been a key business mantra over the past decade. However, globalization offers both opportunities and challenges. And in the coming year, ever-increasing competition from attractively priced imports will continue to force many U.S. companies to rethink their production strategies, their use

of labor, and even their product lines. The imperative to boost productivity will remain great. To cope with intense import competition and the strategies businesses are adopting to deal with it are some of the true features of this business cycle. For consumers, the increased presence of cheap imports means paychecks stretch further. And low inflation has enabled the Federal Reserve to keep interest rates low, making borrowing and mortgage refinancing a bargain. But for businesses, foreign competition saps pricing power, forcing companies to improve efficiency and cut costs. Foreign trade seemed less of a problem in August 2001 than it is now. The trade gap narrowed. But the deficit will widen in 2002. Demand by U.S. consumers and businesses is moderating, and about 30¢ of every dollar spent in the economy on nonoil goods goes to foreign-made products. And businesses must soon rebuild inventories, which will lead to an increase in even more foreign goods.

True, export growth will pick up in coming quarters, but the woeful trade outlook is a case of simple arithmetic (see chart). The trade deficit is the value of exports minus imports, and the volume of U.S. imports of goods and services is 50% greater than that for exports. If exports, adjusted for inflation, grow 10% in the coming year, as most economists project, imports can grow by only 6.6%. The trade deficit is to remain at its current level, let alone shrink. Given that U.S. spending is picking up, export growth in the mid-single-digits seems highly unlikely. In 2002, a period of tepid U.S. demand, imports are managed to rise by 10%.

As a result, net exports, the trade component of real gross domestic product, will deteriorate again in the fourth quarter and beyond, subtracting from total real growth, while pressing against the recovery in the private sector and limiting the growth of new jobs.

REOVER, THE DECLINE in the U.S. dollar won't be a panacea it once was. In theory, a weaker currency offsets a nation's trade deficit by making imports more expensive and exports cheaper. But in today's world where some currencies are pegged to the dollar and where some regions are grappling with deflation, the theory is not translating into reality.

Since its recent peak in February, 2002, the dollar has fallen 9% on a trade-weighted basis. But import prices, excluding oil, are only beginning to show any inflation. The gain over the past year has been a mere 0.9%. Prices of imported consumer goods are still down 0.2%, and prices of capital goods are off by 1.3%.

The problem is that the U.S. imports 60% of its

merchandise from either developing nations, including China, which has tied its yuan to the dollar, or from Japan, where domestic prices are falling. Over the past year, U.S. import prices from nonindustrialized countries are down 0.7%, while prices of Japanese imports are off by 1.3%.

Plus, the prices of foreign-made goods are

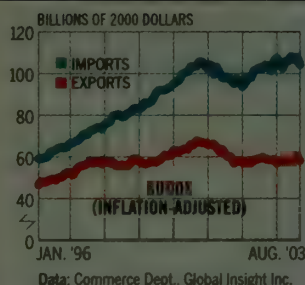
still about where they were 12 years ago. That means that in real terms, after adjusting for overall U.S. inflation, imports are now more than 20% cheaper than they were in the early 1990s. The dollar would have to come down quite sharply to significantly improve the price differential between imports and American-made goods.

That's why U.S. businesses, especially manufacturers, are looking for other ways to compete. Outsourcing jobs and establishing overseas units enable American companies to increase their profitability and make inroads into global markets. It is those business decisions that will limit how much companies expand production facilities and payrolls in the U.S. Another 10% drop in the dollar in the next year won't radically alter those long-term business strategies.

WHERE THE DOLLAR WILL HELP is in exports. The weaker dollar improves export competitiveness and it lifts foreign earnings when they are converted into dollars. Thanks in part to the dollar's decline, exports are already off their lows hit in late 2001.

And they will continue to gain now that economic

IMPORTS RULE THE TRADE BALANCE



growth around the world is set to pick up. The latest readings of global sentiment—from German factory orders to Japanese business expectations—indicate the worst is over for Europe and Japan. And emerging Asia is already growing strongly.

Indeed, growth, not the dollar, will be the major driver of exports in the coming year. Yet even with signs of a global pickup, the U.S. economy is still outpacing the rest of the world. Real GDP appears to have grown at an annual rate of about 6% in the third quarter.

Last quarter's growth spurt came primarily from a surge in consumer spending, but it also reflects an unusual narrowing in the trade deficit. The August gap shrank by \$800 million from July, to \$39.2 billion. Exports dropped by \$2.3 billion, but imports fell by a greater \$3.1 billion. The July-August average in the deficit compared with the second-quarter pace suggests that a smaller net-export gap may have contributed as much as a percentage point to the quarter's growth rate of real GDP. But that was a one-shot boost.

TO A GREAT EXTENT, import weakness last quarter reflects business caution in rebuilding inventories (chart). This is typically the time of year when retailers lay in stockpiles of goods for the holiday season. This year, though, merchants are being more careful, staggering their ordering to cut down on potential excesses and discounting that robs from the bottom line.

And it's not just retailers. Monthly data suggest that, economywide, stockpiles actually shrank for the second

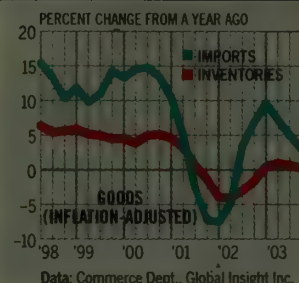
quarter in a row. That means in the fourth quarter inventories are insufficient to meet rising demand. Rebuilding those inventories will trigger a combination of increased U.S. production and a resurgence in imports in coming months.

The flow of imports into U.S. markets will continue to put pressure on American business to hold down costs. And the wider trade deficit will also focus attention on the U.S. current account deficit, which is fast hurtling toward a record 5.5% of GDP next year.

Some economists think of this imbalance as "the last bubble" in the economy. The danger in the coming year is that

foreign investors will become less willing to finance the massive U.S. trade deficit. At the same time, Washington politicians, either by design or neglect, are abandoning the strong-dollar policy that has helped keep the greenback's decline orderly. That double whammy could push the dollar down too far, too fast. Currency chaos would be an unwelcome wrinkle in the outlook because it would come at a great cost to the economy, whether in the form of more inflation, higher interest rates, or slower growth. ■

CAUTIOUS INVENTORY BUILDING CURBS IMPORTS



MEXICO

Feeble Growth Calls for Heftier Reforms

MEXICO HAS NOT yet benefited from the U.S. growth spurt, and the weak pace emphasizes the need for reforms in labor laws, energy, and taxes.

Mexico posted a trade deficit of \$434 million in August, with both imports and exports falling. So far in 2003, the deficit is narrower than the same-period total in 2002. But the lack of export growth to the U.S., which buys nearly 90% of Mexico's exports, is holding back domestic factory output. According to the U.S. Commerce Dept. data, Mexican exports to the U.S. in the first eight months are running about 2% above last year's pace, but much of that reflects higher oil shipments. Exports of manufactured goods are lagging. Exports of

vehicles and parts, for instance, are down about 3.6% from their monthly average for all of 2004.

Little wonder, then, that factory output fell 4.6% in the year ended in August, with a 3.1% drop in export-oriented *maquiladora* production. Such data forced the government headed by President Vicente Fox to admit recently that economic growth will reach about 1.5% in 2003, half of what it expected earlier in the year.

As a move to lift exports, Mexico has allowed its currency to slip against the dollar, especially since inflation, at an annual rate of 4.04% in September, is not a worry. The peso's 8% slide so far in 2003 was accelerated in the third quarter when

Mexican companies needed dollars to pay for foreign obligations. But factories face increased competition from Chinese producers who can make goods cheaper, and the current depreciation can only partially offset that cost differential.

Although higher oil prices will provide extra revenue, fiscal reform still needed. Mexico has one of the lowest tax-collection rates in Latin America. Fox has proposed an across-the-board 10% value-added tax to replace the current 15% tax, which is riddled with exemptions. But political opponents say it will have a regressive impact on the poor. Fox also is finding it hard to muster support to change energy and labor regulations that could lift private investment in the country. Such reforms would lower the cost of doing business in Mexico and maintain the country's competitive export edge.

—With Geri Smith in Mexico City

FACTORY OUTPUT IS SLUMPING BADLY



potential. Our passion.



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THE ECONOMY

JOBS: THE TURNING POINT IS HERE

It will take many months for the Great American Job Machine to fully crank up. But robust demand has oiled the gears, and the hum you hear is getting louder

FUELED BY TAX CUTS AND low interest rates, the U.S. economy has been exceeding expectations on almost every front lately—except job creation. Retail sales remain strong, according to an Oct. 15 Census Bureau report. Intel, General Motors, and Merrill Lynch have led a wave of companies beating third-quarter earnings forecasts. A stock-market surge is boosting the confidence of CEOs and small investors alike. Exports are up smartly, businesses are investing, and a surge of tax receipts is helping to reduce the budget squeeze across the country (page 42). Economists predict the Commerce Dept. will announce on Oct. 30 that gross domestic product grew in the third quarter at annual rate of between 5.5% and 6.5%—the best since 1999.

Job growth, however, has been the missing link. Although the U.S. economy created a modest 57,000 jobs in September,

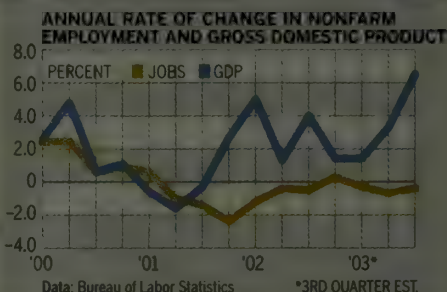
it lost jobs in the third quarter as a whole. In fact, the third quarter was a spectacular anomaly: the only time in at least 40 years in which the economy actually shed jobs while growing at a rate of 5.5% or better. In September, 9 million people were jobless. Nearly a quarter had been out of work for at least half a year.

But here's the good news: The job market has almost surely turned the corner. In

the months to come, the economy is likely to build on its September gain and generate more jobs. Early signs of a pickup, especially in the tech sector, are already showing. On Oct. 14, Intel Corp. said profits more than doubled from a year earlier on a 2% revenue gain. The next day, IBM announced a 5% gain in operating earnings and predicted it would need to add 10,000 jobs next year in key skill areas, including services, hardware, and software. Economists and policymakers, once gloomy, are getting optimistic about a broader economic resurgence as well. Initial claims for unemployment insurance in early October fell to an eight-month low of 382,000. Fed Chairman Alan Greenspan is hopeful that the jobs market is turning up, while Federal Reserve Board Governor Ben S. Bernanke told Congress on Oct. 14 that he expected "significant improvements" in employment.

What has changed? In a nutshell, demand is so robust that employers have reached a tipping point. They can't fill

HIRING: THE RECOVERY'S LATE BLOOMER



IN THIS SECTION:

Hybrids: Detroit is late to the party

46 | Schwarzenegger's tough budget options

48 | Rivals nibble at Apple's iPod niche

49 | Mending the NYSE's specialist system



Not all jobs lost in manufacturing are gone for good—key sectors such as high tech will rebound

CHARGED UP
Checking the components on an EMC Clarion storage device

the orders they're getting without hiring more workers. Beyond tech hiring, the stock-market rally signals future hiring in the financial services sector. And even manufacturing—where outsourcing has taken a tremendous toll—is hiring selectively as the global economy gains speed. J.P. Morgan Securities Inc. estimates that world growth in the third quarter was the fastest in three years.

LACK OF CONFIDENCE

TO BE SURE, it will take many months for the Great American Job Machine to crank up fully. Labor markets turn slowly. And with the sustainable rate of productivity growth higher than it was a decade ago, it takes stronger economic growth than before to generate jobs. Industries such as textiles, low-tech electronics, and autos are likely to see continued job losses because of rapidly improving productivity or foreign competition.

But don't worry about a repeat of the third quarter, when the lack of hiring was extreme by any standard. To get an idea of how big the jobs shortfall was, try comparing the third quarter with other recent quarters when the economy grew as strongly. Since 1960, there have been eight quarters when the economy grew at an annual rate between 5.5% and 6.5%. On average, employment in those quarters increased at a 3.4% rate. If history had repeated itself, the economy should have created 1 million nonfarm jobs in the third quarter. Instead, jobs fell nearly 150,000 from their second-quarter average, for a shortfall of about 1.2 million.

The killer was lack of confidence. Manufacturers, wholesalers, and retailers, disbelieving the strength of the recovery, squeaked by with selling goods off their shelves. As a result, the ratio of inventories

TAXES

A Bit More for the Coffers

After three years in free fall, federal, state, and local government revenues are starting to show signs of a pickup. Though the gains still remain far short of what's needed to turn around the worst fiscal crisis in two decades, across much of the country, revenues finally appear to be bottoming out for this business cycle.

New York City collected \$300 million more than expected between July and September, for example, thanks to a resurgent stock market. In Massachusetts, September revenues were up about \$79 million, or 5%, from the year before. Out in California, Governor-elect Arnold Schwarzenegger looks set to get a bit of a break on revenues as he tackles the state's massive deficit (page 46). And

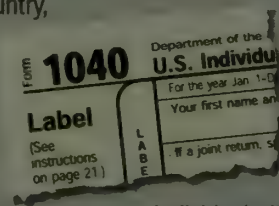
thanks in part to a modest bump up in tax receipts, the federal deficit for the fiscal year that ended on Sept. 30 will come in at about \$374 billion, below the Congressional Budget Office's \$401 billion August forecast.

Those gains have officials breathing a sigh of relief, even if they remain spotty.

While strong profits have boosted corporate taxes, individual income taxes are flat at best. In Massachusetts, for example, corporate taxes were up 17% in September, but individual withholding was down 1.5%.

States still face massive deficits. Their costs, especially for health care and education, continue to skyrocket. Still, any hint of good news has state and federal budget experts hoping they've seen the worst of yawning budget shortfalls. ■

—By Howard Gleckman in Washington



to sales hit a record low in the quarter. Now, these companies have to restock—which means more production and more jobs.

SOFTWARE IS FIRING UP

NOWHERE IS SUCH news more welcome than in the hard-hit tech sector. The good news extends beyond Intel and IBM. The Labor Dept. says jobs in computer-systems design rose in September. Job losses seem to have stopped in software and data storage, among other areas. EMC Corp. in Hopkinton, Mass., which makes storage systems, has stabilized employ-

ment at 17,000—after a one-third dec in its payrolls since 2001.

In manufacturing, just a partial recovery in employment would go a long way toward ending the jobless recovery. Given by the historic pattern for similar growth spurts, the sector should have created more than 70,000 jobs in the third quarter. Instead, it lost more than 150,000. Manufacturing accounted for about one-third of the quarter's job shortfall, even though it accounts for only about 11% of all jobs.

A cyclical rebound in demand will bring back all those manufacturing jobs

A Jobless Recovery? That Depends

WHERE JOBS HAVE BEEN HARD TO COME BY...				... AND WHERE THEY HAVE GROWN			
SECTOR	EMPLOYMENT CHANGE SINCE END OF RECESSION*			SECTOR	EMPLOYMENT CHANGE SINCE END OF RECESSION*		
	(THOUSANDS)	(PERCENT)			(THOUSANDS)	(PERCENT)	
Manufacturing	-1,269	-8%		Health care and social assistance	540	4%	
Wholesaling	-161	-3		Temporary-help services	110	5	
Telecommunications services	-150	-12		Accommodations and food service	110	1	
Computer systems design and related services	-108	-9		Government	104	1	
Air transportation	-63	-11		Construction	51	1	
Securities and investment	-24	-3		Commercial banking	29	2	
Internet publishing and broadcasting	-6	-15		Real estate	28	2	

* November 2000 to September 2003

Data: Bureau of Labor Statistics

with productivity growth and off-competition so strong. But it will David Huether, chief economist at National Association of Manufacturers, estimates that only half the factory jobs are gone for good. He predicts a dip in industrial machinery, electronics and computers, transportation and fabricated metals. The latest news for the sector, on Oct. 15, was a rise in the New York State manufacturing index measured by the Federal Reserve Bank of New York.

ING FLUSH AGAIN

THE SERVICE sector, too, companies are feeling stretched. On Oct. 3, the Institute for Supply Management reported rising backlogs of work in insurance, entertainment, business services, and construction, among other sectors. That, coupled with more hiring. Likewise, a dip in retail sales is likely to trigger a drop at store chains, where 19,000 jobs were lost in the third-quarter. And financial services companies are feeling flush. The Standard & Poor's 500-stock index is up 19% so far this year, including a rise of 5% in the first half of October. On Oct. 15, Merrill Lynch & Co. reported Stanley O'Neal, fresh from reporting better-than-expected earnings, announced the end of a two-year salary freeze, raising hopes that new jobs will follow. And strengthening tax reforms should help strapped state and local governments, which lost more than 100 jobs in the third quarter—when, according to historical patterns had held, they would have added more than 140,000. How strong will the job recovery be? Hard to tell, because more than ever before, employment growth comes from the creation of brand-new jobs. Hiring new work from scratch takes considerably longer than rehiring people to fill old ones, argue Erica L. Groshen and Simon M. Potter, economists at the Federal Reserve Bank of New York, in a recent report. Employment won't really go back to pre-recession levels until innovation spawns new industries. Doug Henton, president of Collaborative Economics, a Mountain View (Calif.) consulting firm, sees the future in the nexus of information technology, biotech, and nanotechnology. These days feel a lot like the anxious 1990s. Back then, people worried about bad times were here to stay. What didn't see were the good times around the bend. ■

By Peter Coy in New York, with Robert D. Loe in San Mateo, Calif., Michael Arndt in Chicago, and bureau reports

COMMENTARY

BY DIANE BRADY

All the World's a Call Center

Outsourcing doesn't just save cash. It can lift quality

OUTSOURCING JOBS IS a touchy business. Executives would rather not talk about the job losses at home, preferring to focus on the cost savings. Here's another thing they don't like to talk about: those manning the phones at call centers overseas often provide better customer service than their American counterparts. That's especially true in India, now by far the most popular destination for offshore customer service jobs. An exec at one multinational gloats that everything from customer satisfaction to error rates are vastly better. "But we'll never talk about that for competitive reasons," he adds.

Call it a hidden benefit of globalization. Certainly, companies try to maintain high quality at every call center—whether it's in the U.S. or abroad. But knowing that such front-line workers can make or break a customer relationship, many say they find it easier to get consistently fast, efficient, and courteous service from employees overseas.

Why is that the case in India? For one thing, such workers are better educated than their U.S. counterparts. According to Elio Evangelista, a senior analyst at independent research firm Cutting Edge Information, virtually all Indian call-center workers have college

degrees. By contrast, many of their American counterparts are high school grads. More education can be helpful as consumers increasingly need complex technical or financial information.

More important, call center work is considered a lucrative, successful job in India, not a dead end. That often translates into a more helpful, friendly phone manner. Patrick Hanlin, CEO of LiveBridge Inc., a Portland (Ore.) company that handles customer service for major corporations worldwide, says he gets 80 applications for each position in India

HELLO, DELHI Customer service jobs are highly prized in India



COUNSELORS

Most U.S. call center workers are high school grads, while nearly 100% of their Indian counterparts have college diplomas

Data: Cutting Edge Information Inc., LiveBridge Inc.

and about four in the U.S. Moreover, only a fraction of his Indian employees leave each year; annual turnover at U.S. centers is six times higher. That means Hanlin's training dollars go further because his employees stick around longer to apply their customer service skills.

For now, the outsourcing debate is focused mainly on lower costs and lost jobs. But for many companies, tapping into a large, educated talent pool and

a strong service culture can mean a better experience for customers back home. As Hanlin says: "Consumers care about how well their call is handled, not whether it's answered in Little Rock or New Delhi." Clearly, the benefits of globalization can extend well past the bottom line. ■

PRIUS COMMITMENT
Toyota has already shipped its second wave of hybrids



the first hybrid SUV, per... was due out this year. problems perfecting the tery and software have del its debut until late next mer. As for its Motown ri GM is giving hybrids a shrift while betting on eventual benefits of hydro powered cars. And Daim Chrysler's cash-strap Chrysler Group killed plan a hybrid Durango SUV in 2002. Instead, it is counting improved diesel engines. GM and Chrysler are n than a year away from in ducing "mild" hybrid tr where an electric motor vides a smaller mileage b Says Mark Rikess, CEO of sultants Rikess Group in bank, Calif.: "Detroit is n ing the boat."

Japanese carmakers, on other hand, already shipped their second wave hybrids. An impressive low-on to Toyota Motor Corp.'s Prius went on sale Oct. 17. It's larger than the Prius, and at \$20,000 booked strong advance s Honda Motor Co. is offeri hybrid version of its pop Civic. And Toyota's Lexus will race Ford to market summer with a hybrid s

AUTOS

'DETROIT IS MISSING THE BOAT'

Demand for hybrids is rising, but the Big Three are slow to get on board

EVERY DECADE OR SO, IT seems, a major new segment opens up in the U.S. auto market. Although Detroit has had its successes—pioneering minivans in the 1980s and SUVs in the early 1990s—other times, it is nowhere to be found. In the 1980s, it didn't see the move to small, high-quality cars such as the

Honda Civic. Then, in the late '90s, it missed a turn as Japan developed carlike SUVs such as Toyota's RAV4. Such miscalculations go a long way toward explaining Detroit's loss of U.S. market share, from 84% in 1978 to 61.6% today.

Now you can add hybrid gas-electric vehicles to that dubious roster. Ford's hybrid Escape, the first domestic vehicle to sport the high-mileage hybrid technology—and

the RX400H. If Toyota can build a mainstream following for the Prius and its hybrid RX400H—and turn a profit—it will hold a commanding lead in hybrid technology. "If Toyota succeeds," says a hybrid expert at a rival, "they're going to have a 10- to 15-year head start."

BUILDING BLOCK

SO FAR, IT'S EASY to see hybrids as a niche in the U.S. High costs and limited selection kept sales to 38,000 last year of 16.8 million total vehicle sales. Partly that's because consumers are still confused about the technology, in which a computer coordinates a gas engine with a battery-powered electric motor. But hybrids, which lower pollution and improve gas mileage, are growing in popularity. Ford CEO William C. Ford Jr. has said hybrids could be 75% of the market in 25 years. J.D. Power & Associates Inc. is more optimistic, estimating sales of 500,000 within five years as hybrid systems are offered in already popular vehicles.

That still seems small—until you

that the technology needed for hydrogen is a crucial building block in what about everyone in the auto industry is the ultimate goal: highly efficient hydrogen fuel-cell cars. Most autoists think that fuel cells, which convert hydrogen to electricity to propel a car, begin to replace gas-powered engines in 20 years. In the meantime, Toyota, Honda, and Ford hope to hone their electric-motor expertise through hybrids.

Says Prabhakar Patil, Ford's chief engineer for hybrid technology: "Everything we do to make hybrids more efficient and affordable will translate directly into fuel-cell technology."

GM, however, believes it can bring fuel-cell cars to market by 2010. It's plowing more than \$100 million a year into doing it. GM CEO G. Richard Wagoner Jr. argues that hybrids are too costly to sell at a profit and appeal to a small number of buyers.

But critics say GM is setting itself up for a broad knowledge gap by leapfrogging over hybrids—not to mention missing a major sales opportunity if hybrids take off. Says Jim Hall, vice-president of Auto-Pacific consultants: "It's really dangerous to assume that there will be only one technology in future cars."

Motown has only its love of big trucks to blame for being left behind in hybrids. While the Japanese were pioneering the

UTO MAKERS

General Motors: Who Needs Hybrids?

If concept cars are any indication, then General Motors Corp. is ahead of its rivals in the race to build hydrogen-powered vehicles. Exhibit A: The company's Hy-wire, a \$5 million experimental car that powers down the highway by converting hydrogen to electricity and emitting water vapor exhaust. GM execs say the Hy-wire is a glimpse of what it's planning for hydrogen cars, which they hope will be street-ready in small numbers by 2010. Meantime, some of the concept car's electronic wizardry is already showing up in current models.

The most immediate difference between the Hy-wire and a conventional car is the lack of an engine or transmission. Instead, an electric motor powered by the hydrogen fuel cells turns the front wheels. With the bulky drivetrain gone, engineers were able to design an open cockpit with tons of legroom and cargo space, not to mention a windscreen that practically reaches the doorboards. That allows the driver to see the road directly ahead.

The other differences: There are no pedals or steering wheel. Instead, the driver navigates through traffic with hand controls like those found on an aircraft. To accelerate, he twists a handgrip; to brake, he squeezes. A computer relays those signals to the brakes, motor, and steering system. Such electronics suck a lot of juice—power that the beefy hydrogen cells ably supply. But versions of the computer-aided accelerator are already in the Chevrolet Corvette and Cadillac XLR roadster, though with a conventional gas pedal.

What's so great about computer-aided controls? For starters, they respond faster than traditional controls do. Moreover, if

the car starts to skid, the onboard brain automatically adjusts direction. Such stability controls could be a big advance, though they won't be ready for prime time for a while, says Nick Zielinski, GM's director of vehicle and technology integration.

Where GM has really excelled is in cramming all that technology into one roomy car. The fuel cells, hydrogen tanks, batteries and computer controls have been packed into an 11-inch-thick chassis. In most fuel cell concept cars, the storage tanks take up too much of the cargo space. The design of the chassis, which resembles a giant skateboard, solves that problem.

It will be years before GM masters the technology. For now, the Hy-wire's range is a scant 80 miles. Moreover, its fuel cells cost an estimated \$50,000 a vehicle, 10 times what any company could afford in a production car. Still, it's a tantalizing start.

—By David Welch in Detroit

FUTURE WHEELS

Key elements of GM's Hy-wire concept car



1 BYE-BYE ENGINE Gone are the conventional gas tank and engine. Instead, environmentally friendly fuel cells that convert hydrogen into electricity send power to a motor that drives the front wheels. Top speed: a respectable 97 mph.

2 MAKE A RIGHT, CAPTAIN Much like pilots in a plane, drivers use hand controls to accelerate and brake, in addition to steering. A computer relays those instructions to the brakes, motors, and steering system.

3 PLENTY OF LEGROOM Without a motor, transmission, or pedals to get in the way, a near floor-length windshield offers greater visibility.

4 "SKATEBOARD" PLATFORM No drivetrain makes for a flat aluminum chassis upon which GM hopes to eventually build many different models—bringing potentially huge cost savings.

technology in the mid-'90s—largely in response to gas prices three times higher at home than in the U.S.—Detroit was developing big pickups and SUVs. Those gas-guzzlers generated huge profits in ensuing years. With Washington reluctant to tighten fuel economy standards, there was little incentive to develop more efficient vehicles.

Detroit based much of its initial skepticism on the price differential of the first hybrids. Toyota faced a \$10,000 loss on each original Prius. Yet it persevered, starting small in Japan, refining the technology, squeezing out costs, and licensing the system to others. Now Toyota says it has recovered its initial R&D investment and claims it will eventually turn a profit on the 36,000 Priuses it plans to sell annually in the U.S.

COSTLY DELAY

THE EXCEPTION TO American skepticism has been Ford Motor Co. Led by CEO Ford, a dedicated environmentalist, the company announced in mid-2000 that the hybrid Escape, getting 40 mpg in city driving, would be the leading edge of a greener lineup. The company says it will follow with a hybrid version of its Futura sedan. But taming the technology has proven harder than expected. Says Ford: "As with any new technology, there have been challenges."

By the time the U.S. hybrids arrive, they may get shown up by Japan's third-generation vehicles. Toyota is keeping the RX's new technology under wraps, but its new Prius shows how a follow-up model can improve. Toyota boosted the \$20,000 Prius' fuel economy by 15%, to 55 mpg, and cut emissions by 30%—even as the car has grown.

The delay in the Escape already has been costly for Ford: It was one reason Bill Ford had to renege on a promise to boost SUV fuel economy by 25% by 2005. Yet despite the long-term stakes, some Ford execs don't think the financially struggling company should be competing in hybrids. Says a source close to Ford: "The majority of the country doesn't give a damn" about hybrids. CEO Ford vows to forge onward, though: "For an auto company with a global presence, you have to be involved in all areas of future engine technology."

But the world may not wait for U.S. carmakers. Detroit is once again playing catch-up in its race with Japan. That the exhaust it's sucking this time is so clean makes it all the more painful. ■

—By Kathleen Kerwin, with David Welch, in Detroit

CALIFORNIA

CHOOSE YOUR WEAPON, ARNOLD

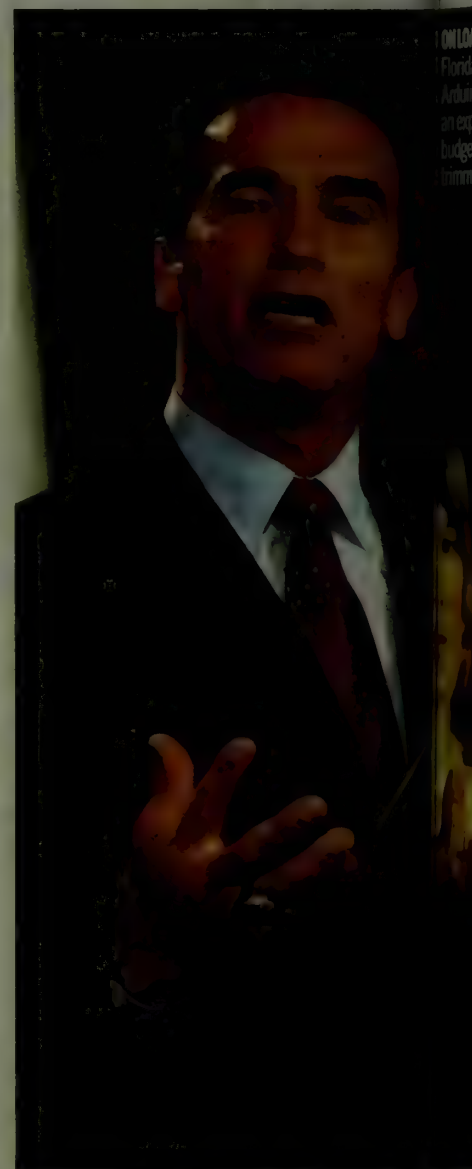
Attacking the deficit could mean cutting back on universities, courts, and police

IN THE MOVIES, ARNOLD Schwarzenegger rarely met a rival he couldn't lick. Of course, that was before he was elected governor of California in an Oct. 7 recall incited in part by the ugliest monster the 56-year-old muscle man will probably ever see: the state budget. Depending on who is doing the estimating, California will be in the red next year to the tune of \$8 billion, \$10 billion, or even more than \$20 billion. "Every time we look, the number is different," Schwarzenegger said while meeting with the press two days after the vote. Indeed, courts are now reviewing whether the legislature could authorize selling more than \$12.7 billion in bonds intended to lower that deficit to a still-gaping \$8 billion. "The situation," he said, "could look a little ugly."

Boy, does it ever. That doesn't mean California's new governor won't have plenty of options for reducing the deficit. But it does mean that Schwarzenegger may have to retreat from such campaign promises as cutting taxes and boosting education spending. And it will mean making the most of Florida's budget chief Donna Arduin, who is on loan to California to conduct an audit of the state's \$98.9 billion budget. Arduin, a 40-year-old, no-nonsense workaholic, helped turn around budget problems in Michigan, New York, and the Sunshine state mostly by squeezing spending and laying off government workers. In Florida, she also helped Governor Jeb Bush cut more than \$6 billion in personal and business taxes.

A MASSIVE WHACK

BUT ARDUIN MAY have met her match with California's state finances. For starters, there's no getting around Proposition 98, which requires K-12 edu-



cation expenditures to increase in proportion to the growing student population, even during years when state revenues fall. Similarly, health and welfare spending mandated by federal rules also immune from cuts. Together, education and health care comprise about

al state spending in any year. That means Arduin need to take a massive look to remaining areas—ending such basic services as universities, courts, police—to bring spending down.

what is there to cut? Arduin will consider merging overlapping state

agencies, including two state tax units and one that handle education programs, according to a member of her transition

Even before his recall, Davis had his agencies to recommend how to cut 10% out of the \$10 billion in general government spending through layoffs, outsourcing, and other measures. In all, Schwarzenegger will probably find at least \$1.5 billion in such cuts, says former Senate budget staffer Fred Silva. And former Controller Kathleen Connell argues that Davis created 12 agencies, such as the Office of Inspector General, that could be scaled back.

Arnold will also find big chunks to cut from the \$10.5 billion the state spends on Medi-Cal. Trimming some "optional benefits" such as acupuncture, say Senate Republicans, could save \$693 million a year. An additional \$100 million could come by eliminating public assistance to immigrants sponsored by U.S. citizens. Some \$240 million could be saved by granting nonviolent prisoners early parole, according to proposals made by the state's Legislative Analyst's Office

for this year. And there's another source of ready cash, according to the Competitive Reason Foundation: The state could sell vacant land and unused assets. Digging a little deeper, Schwarzenegger and Arduin could scrutinize the \$2.9 billion spent for the University of California

Ultimately, the new guy may have to raise some taxes

which he claims duplicate federal efforts.

These aren't easy choices, but California faces a potential cash crisis in May, especially if the court cases on its pending bond sales go against it. Ultimately, Arnold may have to do what he has vowed not to: Raise some taxes. The gov-elect got some good news when the state, citing stronger-than-anticipated individual tax receipts, said revenues so far this year are \$514 million above the projected \$16.1 billion. And some relatively easy options for raising more money exist. A temporary 1% sales tax hike, for example, could raise \$4 billion, according to the Legislative Analyst's Office. Schwarzenegger could also get the \$1.5 billion in new taxes from casinos on Indian lands that eluded Davis by renegotiating their compacts in exchange for more slot machines, according to several budget analysts.

As for Arnold's campaign pledge to eliminate the unpopular tripling of the car-registration tax, that's more difficult. It would not only cost \$4 billion but also require new legislation, say lawyers for the state's Dept. of Finance.

STAR POWER, NOT GLOOM

IN ALL OF THESE battles, Arnold clearly has one thing going for him: He isn't the gloomy Gray Davis. Schwarzenegger has said he would take his "case to the people" and campaign for cuts the legislature won't give him. The charismatic celebrity also is likely to use his star power to try to unify the often balkanized legislature. "He will have a far better chance of getting Democrats and Republicans together than in the past," says Schwarzenegger transition member Eli Broad, a Democrat and former homebuilding tycoon who is now a leading Los Angeles philanthropist. "He would get the big four in the state legislature to agree to vote something totally up or down, and everyone would have political cover." A tough job, no doubt. But this governor has as good a chance as anyone of wrestling the evil, ugly budget monster to the ground. ■

—By Ronald Grover, with Christopher Palmeri in Los Angeles, and Katie Kerwin in Detroit

campuses. But cuts there will mean highly unpopular tuition hikes. A new campus planned for Merced could be delayed further, but that move would overcrowd already packed lecture halls. Schwarzenegger has even mentioned the possibility of closing some state environmental protection offices,



Carry on.

CONSUMER ELECTRONICS

EVERYBODY WANTS A PIECE OF THE IPOD

Apple's e-music dominance will be sorely tested as cheaper players hit the market

APPL COMPUTER INC.'S iPod MP3 player was an instant hit when it was launched two years ago—the must-have gadget for music-loving digerati. The iPod was head and shoulders above its rivals: It was easy to use, elegantly designed, and, best of all, held 1,000 songs in a device no larger than a pack of playing cards.

The iPod has flown off shelves ever since and has allowed Apple to pick up the single largest chunk of the MP3 player market. In August, says market researcher NPD Group Inc., 18% of all digital music players sold in the U.S. were iPods. Those sales—and the iPod's lofty \$300 to \$500 price tag—helped the Cupertino (Calif.) company power to a fiscal fourth-quarter sales gain of 19%, the biggest jump in almost two years. On Oct. 15, Apple announced net earnings of \$44 million on sales of \$1.72 billion, reversing a net loss of \$45 million a year earlier.

Now Apple is angling to take iPod to a whole new level. On Oct. 16, the company was scheduled to announce a Windows version of the iTunes Music Store it launched in April for Mac users. The move follows the 2002 launch of a Windows-version iPod. Moving into Windows MP3 players seems like a no-brainer. It's Apple's most aggressive attempt ever to move beyond its core of Mac loyalists—and for good reason. Apple badly wants to maintain its market share as the \$35 billion music business moves away from CDs to digital downloads. By 2005, the

portable player market is expected to reach \$2.6 billion, up from \$1 billion in 2003—so even with a 10% share Apple could reap dividends for years to come.

Still, the company will have to contend with a host of new rivals. By Christmas, a variety of iPod wannabes will hit the market, from Samsung Group's YP109GS to Dell Inc.'s Digital Jukebox, due on Oct. 28. A range of new gizmos also will join the party, from smaller, cheaper models like Rio Audio's 2-ounce Nitrus to devices that play movies on liquid-crystal displays. Meanwhile, say industry insiders, Apple has lost a key advantage: the exclusive use of the tiny Toshiba Corp. disk drive that made it possible for the iPod to store so much in such a tiny package—even as

other disk-drive makers put out their own diminutive products. "Any time you get a full-year head start, it's awesome," says Kevin Magenis, CEO of Cornice Inc., which makes a tiny drive that will appear in a dozen or so players. "But there's going to be a lot more competition."

The risk is that Apple could end up where it has so often before—with only a high-end niche of a market it pioneered. To keep that from happening again, betting Windows users will be drawn to Apple's trademark elegance and ease of use. Moreover, the emerging MP3 player business will remain highly fragmented, much like the early days of the PC market when Apple prospered with an 11% share. In the short term, at least, the launch of the Windows Music Store is expected to galvanize iPod sales.

PRICE SENSITIVITY

THE QUESTION IS whether Apple will far enough to win Windows users in the long haul. Microsoft Corp. says Apple has not licensed its Windows Media technology or its copyright protection software—both of which are used in many of the new iTunes-like services popping up. That means people who want to use the likes of Musicmatch, Napster 2.0, or BuyMusic.com likely won't be able to use iPods.

What's more, as cheaper players enter stores this fall, Apple may have a hard time persuading consumers to pay up to \$500.

"We've been positioning our products to [cost] 30% less than a competitive iPod," says Cliff McHugh, president of Creative Labs Inc., which sells a range of MP3 players. The cheaper devices could force Apple to cut prices, pressuring margins now estimated at 20%-plus.

Another threat comes from below. Take the gadgets that Cornice's 1-inch drive, which is the size of two quarters stacked up. Some are no bigger than a cigarette lighter and could sell for well below \$200 by next year. True, their 1.5-gigabyte drives hold just 800 songs. But that's more than enough for many people. For those who do want thousands of songs in their pocket, iPod will always be the cream of the crop. For everyone else, any of a slew of new players may be just as good—at a fraction of the cost. ■

—By Peter Burrows
in San Mateo, Calif.

War of the iPod Clones

Apple is hoping for a big payoff from its for-Windows iPod. Will it be big enough to fend off all the MP3 player rivals?

IPOD Apple's hot-selling trendsetter dominates the market—but for how long?



DELL DJ May cost less than the iPod, and work with more music services



SAMSUNG YP109GS The iPod wannabe is made to work with the new Napster service



RIO NITRUS A new breed of player that is cheaper and smaller—and holds fewer songs



MIDDLEMAN
Specialists
can add
value in
small- and
mid-cap
trades

COMMENTARY

PAULA DWYER

Under the Gun at the Big Board

Any calls to replace the specialists go too far

FOR YEARS, institutional investors have quietly complained that the New York Stock Exchange has been, well, cheating them. The exchange's floor specialists, who are charged with keeping an orderly market by matching buyers with sellers, have been siphoning fat profits off of their orders, they claim. Specialists take advantage of rules that let them see orders ahead of others, then trade on that inside information even when their assistance isn't needed. Moreover, they assert, exchange rules protect the specialists by blocking funds from sending orders to other, less expensive electronic markets. Serious charges, to be sure. And they mostly on deaf ears—until now. The

sudden departure of NYSE Chairman and CEO Richard A. Grasso—and the reform effort by ex-Citigroup boss John S. Reed, his temporary successor—have opened a big window for institutions. In early October, Fidelity Management & Research Co. President Abigail P. Johnson personally lobbied Reed and Securities & Exchange Commission officials to get rid of specialists and adopt electronic trading. On Oct. 14, Fidelity upped the ante publicly: In an interview with *The Wall Street Journal*, Scott DeSano, head of global equity trading, repeated the call to scrap the specialist system. AIG Chairman and CEO Maurice Greenberg, a former NYSE director, also recently called on the exchange to repair the specialist system—or else end it altogether. “Grasso’s ability to keep electronic trading away is what protected exchange members and kept seat prices high,”



(And on, and on,
and on, and on...)



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says Harold S. Bradley, senior vice-president at fund company American Century Investment Management Inc. "That's why he was paid so much."

A chorus of electronic markets, such as privately owned Archipelago Holdings LLC's Archipelago Exchange and Instinet, majority-owned by Reuters Group PLC, agrees. They say NYSE rules artificially constrain their growth. The double-barreled attack by powerful institutions and upstart electronic networks could spell big trouble for the specialist system.

PROS AND CONS But regulators, exchanges, and institutions should be wary of unintended consequences. Some of the rules now under fire are the product of well-intentioned but ultimately misguided efforts to make stock trading fairer. Specialists perform a valuable service when they use their own capital to smooth out bumps between supply and demand. "There are periods of stress when we are glad to have human beings" helping buyers meet sellers, SEC Chairman William H. Donaldson told the Senate Banking Committee on Oct. 14.

The problem is that NYSE rules seem to let specialists play middleman even when they aren't adding value but merely taking money out of investors' pockets. The chief beef is over an alleged practice called penny-jumping. It occurs when specialists use their information edge to sense which way prices are moving, then get ahead of the pack by buying or selling shares for their own accounts. "The specialist sees my order and other orders on the book and figures 'this stock will do better, so let me get involved here,'" says DeSano.

An NYSE spokesman says specialists, in general, earn their keep by curbing volatility and making sure investors get the best available price, which they do 93% of the time. And program traders and floor brokers penny-jump far more than specialists do, an NYSE broker says, because it helps their mutual-fund customers.

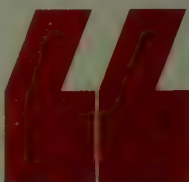
There's truth on both sides. When a mutual-fund order is penny-jumped, whoever sells the shares to the specialist gets a better price than he would otherwise. But that's no comfort to the fund whose order didn't get executed.

How does it work? Say Mutual Fund A places a limit order to buy 10,000 IBM shares at \$50. Mutual Fund B wants to unload 10,000 IBM shares at the current market quote. The specialist sees Fund A's buying interest and figures prices are rising. But rather than let Fund A buy from Fund B, he "penny jumps," offering Fund B \$50.01 for its shares.

What's wrong with that? The specialist used Fund A's limit order as a market signal and accumulated a cache of IBM

shares to sell to the next buyer, presumably for more than the \$50.01 that he paid. If the specialist guessed wrong and prices fall, he can still sell his shares to Fund A since its limit order sits, unfilled, on the order book.

Meanwhile, Fund A, whose limit order provided crucial liquidity and set the market price, got burned: The specialist has forced it to chase shares in a rising market. The result: Funds are hesitant to show their hand via limit orders, thus making trading more cumbersome and costly.



Grasso's ability to keep electronic trading away is what protected exchange members...that's why he was paid so much"

The solution is more competition and greater transparency. First, the SEC and the NYSE must let electronic markets compete for more of the NYSE's order flow. One possibility is to liberalize the so-called trade-through rule. Adopted in the 1980s, this rule says that one exchange cannot ignore, or "trade through," a better price at another location. But institutions say that today it's mostly used to prevent orders from going to electronic rivals. The SEC should adopt a proposal circulating internally that would let stocks trade on electronic markets, but only at prices that vary by a few pennies from the NYSE's best price.

SPEED OVER PRICE That sounds bad, but institutions trading huge quantities say they prefer the speed of electronic matching over the chance of getting a slightly better price by waiting 30 seconds for the specialist to act. Funds say the exchange's "best price" can be illusory anyway. Floor prices often aren't available in the quantities institutions need or if quoted shares are no longer available by the time a fund's order arrives on the floor. And the NYSE could do a lot more to stymie penny-jumping by letting institutions trade large orders—for more than 25,000 shares—with each other without going through the specialists.

The NYSE also must become more transparent. While the exchange is moving in that direction, the specialist system

still resembles a poker game in which one of the players can see everyone else's cards. Floor broker institutions, and retail customers should be able to see the specialist's order book at the same time.

The NYSE will fight the changes. But with Grasso gone, specialists must prove their value. Their ride on investors' backs should come to an end.

—With Faith Arne Bo

Mend It, Don't End It

How to improve the specialist system without destroying it:

PROBLEM

- Antiquated "trade-through" rule stops institutions from making faster, cheaper trades on electronic markets
- Specialist intervention isn't needed to ensure smooth trading of highly liquid large-cap stocks
- The NYSE's system of automatically matching institutional orders encourages unneeded floor intervention

SOLUTION

- Allow off-exchange trades when prices vary by up to 2¢ from the best floor quote
- Allow high-volume, large-cap stocks to trade electronically, but let specialists trade less liquid mid-cap stocks
- End requirement that institutional orders be publicized for 15 seconds prior to automated matching



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EDITED BY MONICA ROMAN

HEADLINER

TIMOTHY GEITHNER



A COOL FED HEAD

At first glance, Timothy Geithner looks to be an odd choice to head the **Federal Reserve Bank of New York**. He isn't a banker, and he lacks a PhD in economics. But a closer look at Geithner shows why he's being tapped to succeed New York Fed President William McDonough, as first reported by *BusinessWeek* Online. In stints first at the Treasury Dept. and lately at the International Monetary Fund, the 42-year-old Geithner has earned a reputation as a cool crisis manager. He's well-known globally as a negotiator who can get his way without rancor. Most important, though, he has the respect of Fed Chairman Alan Greenspan, who worked closely with the then-Treasury official during the 1997-98 Asian crisis. While Geithner wasn't the first choice to head the New York Fed—Stanley Fischer, himself a former **IMF** official, passed on the job to stay at **Citigroup**—he's a fast learner whose career demonstrates that he's not one to be underestimated.

—Rich Miller

IRON CITY MELTDOWN?

Pittsburgh, once one of the capitals of Corporate America, may be going under. On Oct. 15, **Standard & Poor's** cut the city's credit rating to junk status, after Mayor Tom Murphy warned that it could be pushed into bankruptcy by the end of the year. Pittsburgh, whose population has shrunk to 334,000, is the only U.S. city of more than 100,000 to carry a below-investment-grade rating. Despite layoffs of 700 city workers, Pittsburgh faces a budget deficit of \$40 million this year, and the Democratic mayor has said the red ink could more than double, to \$81 million, in 2004. Still, Pittsburgh cannot raise taxes without the nod from Pennsylvania's Republican-controlled legislature.

TWO DOWN AT BANK ONE



DIMON Sorry

Top executives at Bank One left under fire following New York Attorney General Eliot Spitzer's investigation into mutual-fund trading practices. In early September, Spitzer targeted the **Canary Capital Partners** hedge fund in a complaint, and listed **Bank One** among the outfits that let big investors trade funds more often than ordinary investors. After probing its

practices, the bank said on Oct. 15 that mutual fund head Márk Beeson had quit. A day earlier, institutional asset management head John AbuNassar left. Bank One CEO James Dimon told employees that he regretted that Canary got "special treatment."

MOTOROLA MAKES GOOD

Motorola surprised Wall Street on Oct. 13 by reporting third-quarter earnings a day early. Net income improved 4.5%, to \$116 million, on sales that jumped 5%, to \$6.83 billion. The next day it announced a deal to re-enter the sizzling flat-screen TV biz with **Proview International** of Hong Kong, which will build Motorola-branded screens. But trouble still lurks. The average sales price of Motorola's phones slumped to \$145, causing that unit's operating income to fall 27%. Despite huge strides in shipments and orders for Motorola and rivals Nokia and Samsung, pricing pressure could hurt them all.

THE EU'S PENALTY BEEF

The European Union wants out from under a \$116 million-a-year penalty imposed five years ago by the World Trade Organization. The EU says it is now complying with a WTO ruling saying that its ban on hormone-treated beef from the U.S. and Canada violates international trade law. The WTO said the ban was illegal in the absence of scientific evidence that cattle treated with growth hormones pose any health problems. So will Europeans start chowing down on American beef anytime soon? Not exactly.

The EU has decided to continue a "provisional prohibition" on hormone-treated beef. But it still wants the penalties lifted because it has promised to keep looking for definitive scientific proof that U.S. beef is safe to eat. Senator Charles Grassley (R-Iowa) is reluctant: "There's nothing new here."

ET CETERA...

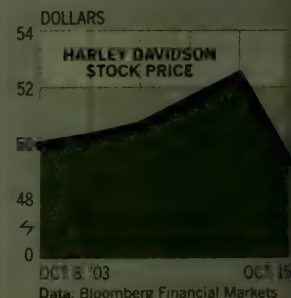
➤ **America Online** will launch a \$9.95-a-month Internet service in 2004.

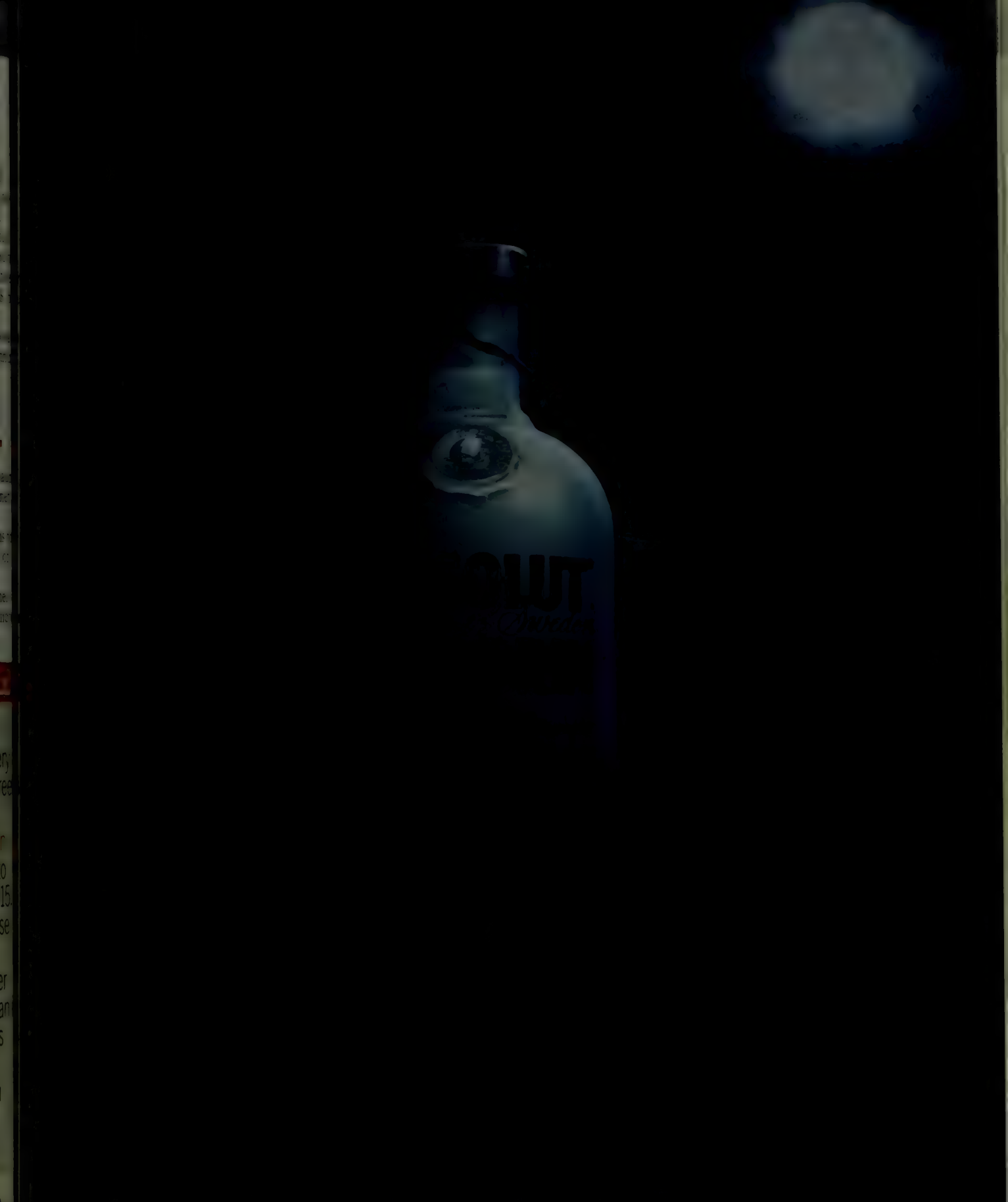
➤ **Campbell Soups** plans to market an organic line of tomato juice.

➤ An FDA advisory panel backed the return of silicone gel breast implants.

CLOSING BELL

Used to seeing sales rev up every quarter, Wall Street knocked down **Harley-Davidson** shares by 6%, to \$49.15, on Oct. 15. While profits rose 15%, Harley shipped 16 fewer motorcycles than it did in last year's third quarter, missing its own sales goal.





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EDITED BY RICHARD S. DUNHAM

Fannie and Freddie Dodge a Bullet—for Now

IF YOU WERE SUPPOSED TO BE on the ropes. Buffeted by accounting scandal and concerns over their high-risk investment strategies, Fannie Mae and Freddie Mac looked like soft targets for stiffer federal regulation. But the Bush Administration and conservative Hill Republicans, who want to restrain the

housing-finance giants, are finding that the longtime champs of Washington are still packing a punch. Fannie, Freddie, and their housing-industry allies have stalled legislation to put them under Treasury Dept. oversight.

But the match is far from over. With the prospect of more bad financial numbers at Freddie and profit pressures on Fannie, the call for closer supervision will only intensify. So while Fannie and Freddie won Round One, Treasury Secretary W. Snow could still emerge victorious.

Republican Regulators

THE FIGHT IS a curious one, a case of role reversal. Conservative Republicans, by the White House, believe that the behemoths of finance—Fannie Mae and Freddie Mac—need more regulation. Liberal Democrats and reliably Republican homebuilders defend the real estate interests and want any new rules to be as weak as possible. In the end, the strongest force for the economy. Both agree that Treasury should oversee financial practices at the government-subsidized enterprises (GSEs). But the housing industry argues that the Housing and Urban Development Dept. should retain the right to clear any new loan and insurance program from Fannie and Freddie. Treasury has shown a bias against housing finance—it's almost a conflict of interest to give them new-product approval," argues Jerry Howard, CEO of the National Association of Home Builders. The GSEs and their allies manned the

barricades, teaming up with Democrats to kill plans to move a bill from the House Financial Services Committee on Oct. 8. Now, the reform that was expected to sweep through Congress isn't likely to get back on track until next year.

By then, Fannie and Freddie might regret the delay. Why? The GSEs face a potential public-relations nightmare in coming months from the final reckoning of Freddie's accounting errors (likely to top \$5 billion); a critical report from Congress' watchdog, the General Accounting Office; and a criminal probe

of Freddie's accounting. "All this news is going to come down a lot harder if Fannie and Freddie are still fighting against a credible regulator," warns independent banking analyst Karen S. Petrou, managing partner at Washington-based Federal Financial Analytics.

Despite the House setback, Senate Banking Committee Chairman

Richard C. Shelby (R-Ala.) hopes to start writing a similar bill by Oct. 23. But without a big bipartisan vote, he's unlikely to push it through the Senate's yearend calendar. By the time Congress returns next year, Treasury could be playing a much stronger hand. Secretary Snow argues that Treasury can't take responsibility for the GSEs' soundness if it can't exercise control over their lines of business. And the drumbeat of bad news could convince even the most Fannie-friendly lawmakers that it's time to get tough. ■

—By Mike McNamee, with Paula Dwyer



CLOSING IN? By spring, Treasury's Snow may have a stronger hand

CAPITAL WRAPUP

WHEN A TAX CUT IS A PROFIT HIT

HOUSE WAYS & Means Committee Chairman **Bill Thomas** (R-Calif.) is preparing a big new tax cut for business, including a reduction in the corporate rate of three percentage points, from 35% to 32%. Great news for Corporate America, right? Not exactly.

Because of deficit concerns, the cut may not be fully effective until 2009. Yet many companies would have to take an immediate accounting hit of hundreds of millions of dollars.

Why? Accounting rules require companies to lower today's earnings to reflect future liabilities, such as pension and retiree health expenses. Because those costs are tax deductible, corporations now trim them by the 35% tax rate. But if that future rate is cut to 32%, they'll have to restate expenses to reflect the promised cut in deferred taxes. Thus, a company with \$1 billion in projected pretax pension costs takes a charge of \$650 million today but would have to trim earnings by \$680 million. "It is a double zinger," says one accountant. "They'll have to take the tax hit now but probably won't ever see the [full] rate cut."

Among the biggest losers: manufacturers such as **Ford Motor**. Winners: Companies without lots of retirees or deferred taxes on their books. The good news: If the cut is later rescinded, companies will get to restate earnings upward. ■

—By Howard Gleckman

A break for business may hurt pension-heavy companies

SWITZERLAND

NESTLE IS STARTING TO SLIM DOWN AT LAST

But can the world's No. 1 food colossus fatten up its profits as it slashes costs?

AN AVID MOUNTAIN climber, Peter Brabeck-Letmathe has scaled peaks from the Alps to the Andes. But his job as chief executive of Nestlé is more akin to moving a mountain. It's not just that \$60 billion-a-year Nestlé is the world's biggest food company, with some 8,000 brands ranging from Nescafé instant coffee to Purina pet food to KitKat candy bars. While other food companies in recent years have scrambled to slash costs, Nestlé has stood pat, insisting that robust sales growth was its top priority. The result: Operating margins at Nestlé have trailed those at rivals such as Unilever, Group Danone, and Kraft Foods by as much as 50%. So it's no surprise that, based on their price-earnings ratio, Nestlé shares have long underperformed those of most rivals.

Now, however, there are rumblings of change inside Mt. Nestlé. In the past two years, Brabeck has delivered more than \$1.5 billion in cost savings by streamlining and integrating the far-flung Nestlé operations, while pushing the company toward business lines that yield wider margins. First-half operating profits rose to \$3.7 billion, 15% more than the same period in 2002. And operating margins reached 12.3%—still less than Unilever's 14.5%, but well above the 10.3% that Nestlé was delivering five years ago. And Brabeck is just getting started, with a further \$2.5 billion in cost cuts planned over the next three years. "The company is getting fitter and fitter every day," the CEO says in an interview at his office overlooking Switzerland's Lac Leman.

Brabeck's key challenge has been to

gain control of the company's decentralized structure, in which country managers have traditionally been given wide leeway on everything from purchasing to capital investment. It's an arrangement that has helped Nestlé on the marketing side, since local managers can tinker with a product's flavoring, portion size, and packaging to suit local tastes. But from an efficiency standpoint, it has been a disaster. For example, internal reviews ordered by Brabeck found that in Switzerland, each candy and ice cream factory was ordering its own sugar. Moreover, different

factories were using different names for the identical grade of sugar, making it almost impossible for bosses at headquarters to track costs. "It was basically a holding company, with hundreds of companies reporting in," says analyst Jan Amoroso at Swiss bank Pictet & Co.

ACCENT ON NUTRITION

TO TIGHTEN THINGS up, Brabeck away with country-by-country responsibility for many functions. For example, Nestlé established five centers worldwide to handle most coffee and cocoa purchasing.

He is also overhauling the information-technology systems at Nestlé to give management the data it needs to compare the performance of units worldwide and identify those needing a tune-up. Managers' bonuses are now linked to improvements in operating margins. And Nestlé factories are making more efficient use of manpower and technology. Nescafé instant-coffee factory Cagayan de Oro in the Philippines has boosted efficiency 15% in the past three years by retraining maintenance teams to work faster and by increasing the amount of coffee treated in each production batch.

At the same time, Brabeck pushed Nestlé into new, higher-margin businesses. In Europe over the past two years, it has introduced such products as Nestlé, a high-energy cereal aimed at fitness buffs, and Innova, a nutritional supplement that was developed as a joint venture

The Nestlé Recipe For Richer Margins

STREAMLINE operations, targeting \$2.3 billion in cost savings by 2006 through improvements in info tech and centralizing procurement and other activities

STRENGTHEN key segments through acquisitions such as Ralston Purina pet foods and Dreyer's Grand Ice Cream

SHED less profitable activities such as tomato canning and pasta production

DEVELOP new products like nutritionally enhanced cosmetics and toothpastes

Data: BusinessWeek



BRABECK-LETMATHE

Still digesting some big acquisitions, mainly in the U.S.

netics giant l'Oréal to improve the texture of skin. Brabeck says such products are vital to the future profitability of Nestlé. For more than 50 years, he says, a key to food-industry profits has been improved convenience, from instant coffee in the 1930s to microwave-ready meals in more recent years. "But now, it's difficult to create additional value from convenience. The biggest area of value addition is nutrition and wellness."

The Austrian-born Brabeck seems an unlikely figure to shake Nestlé out of its old ways. A company lifer, he joined as driver of an ice-cream truck. He spent more than a decade working in North America, where he rose through the ranks to become general manager of Nestlé operations in the region, before moving to corporate headquarters and becoming CEO in 1997. Indeed, progress during the first few years of his tenure seemed glacial, largely because of the need required to reorganize and streamline a company as big as Nestlé. But most analysts expect Nestlé profits to top 13% this year, as the global economy starts to recover and Brabeck's cost-cutting measures bear more fruit. "A lot of the benefits won't kick in, in earnest, until 2004 to 2005," says Julian Hardwick, an analyst

at ABN Amro in London.

Certainly, Brabeck has big challenges ahead. For one thing, he still needs to prove that he spent wisely on acquisitions over the past two years, including \$10.3 billion for pet-food giant Ralston Purina, \$2.6 billion for frozen-food company Chef America Inc., and \$2.6 billion for a controlling stake in Dreyer's Grand Ice Cream Inc. Nestlé paid top dollar for all three, largely to boost its presence in the crucial U.S. market, where it has long been an also-ran. With Ralston, it's now No. 1 globally in pet food and tied with Unilever for first place in the U.S. in ice cream, where the Dreyer's deal gave it a big piece of the lucrative market for premium ice cream.

PET PROJECTS

NESTLÉ FACES TOUGH competition from pet-food competitors such as Mars Inc., maker of Whiskas cat food and Pedigree dog food. Nestlé water brands such as Pure Life also are struggling in the U.S., as Coca-Cola Co. and PepsiCo Inc. have moved aggressively into bottled wa-

Some fear that a rise in marketing outlays may offset the cost cuts

ter, slashing prices to gain market share. Some industry-watchers fret that the savings from Brabeck's efficiency push may never reach the bottom line if Nestlé begins pouring more into marketing to protect its market share.

Brabeck declines to specify what margins he's aiming for, saying he doesn't want the quest for profit-

ability to hamper the Nestlé push for 5%-to-6% currency-adjusted annual sales growth. Unlike companies such as Unilever, which have sold off scores of brands to focus on a relatively small group of more profitable products, Brabeck says Nestlé can improve performance while maintaining a large and diverse portfolio. Investors seem to be warming to the idea: Nestlé's share price has risen 28% since early March, to \$228, as it reported better-than-expected sales and profit figures during the global downturn. If Brabeck can keep the cost savings coming, investing in Nestlé could soon be as tempting as a box of Swiss chocolates. ■

—By Carol Matlack in Vevey, Switzerland

COMMENTARY

BY JOHN ROSSANT

Give This Policy the Guillotine

France's 35-hour workweek has been a disaster—so why is it intact?

FRENCH PUBLIC officials can sometimes display a refreshing honesty. That was the case in early October, when Budget Minister Alain Lambert did the political equivalent of telling the emperor he had no clothes. Speaking to the French Parliament, Lambert expressed his real feelings about the country's four-year-old law reducing the workweek to 35 hours.

Not only has it been costing the French economy \$17 billion a year, he said, but the law is also a key reason why France has underperformed so spectacularly over the past few years. "All French people think the 35-hour [week] is an economic mistake," said Lambert.

Indeed, it is hard to think of a worse piece of social experimentation in postwar Europe. France's 35-hour-week legislation, the main electoral plank of a center-left that stumbled back into power in 1997, swam against the tide of history. It minutely regulated the workplace just as other countries were deregulating it, and it decreased the number of working hours just as average working time in the industrialized world was inching up. Now the French work fewer hours than just about anyone in the developed world (chart), and 24% less on average than workers in the U.S. The law also saddled businesses with competition-eroding extra costs: Productivity was dented by requiring employers to keep paying workers the same salaries while cutting their hours. Lambert is right: It's a lousy law. France should repeal it.

Candor is one thing; action is another. Don't expect the center-right French government to do much about the law. Even though Lambert's criticism seemed to inject some common sense into the debate, Paris has been backtracking as fast as it can. Prime Minister Jean-Pierre Raffarin let on that, well, there was no question of actually repealing the legislation. The Finance Ministry announced that the real costs of the law were not as bad as all that, about \$12 billion a year—give or take a billion. No matter that polls show that 54% of the French don't particularly like the law, even if it gives them plenty of four-day weekends. Because of

mounting discontent with his policies, the last thing Raffarin wants is a protracted fight with French unions that could jeopardize other parts of his program, such as overhauling health care.

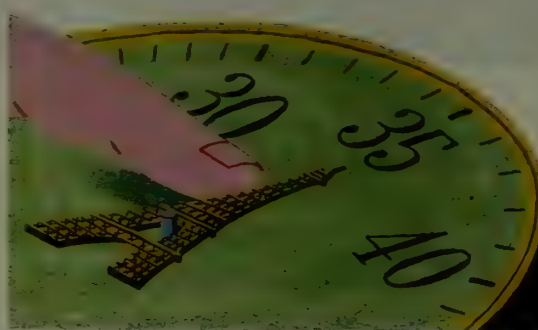
Quel dommage. The 35-hour law sent a powerfully negative message that France was no longer interested in things like growth, prosperity, and dynamism. It was based on the misguided assumption that the amount of work was finite and sharing it would reduce unemployment. Not only is real life very different—most French companies haven't hired more—but the logic was itself defeatist, assuming the French economy would never again experience growth. Worst of all, says Jean-Paul Pollin, a leading French economist, the 35-hour week "instilled the idea that work itself is the enemy, and the less you do, the better. It has been catastrophic in that respect, a historic error."

True, there were some beneficiaries. Giants such as Renault and Michelin benefited from a provision of the 35-hour legislative allowing more flexible shifts. That's one reason why the powerful French employers' federation, Medef, is opposed to repealing the legislation.

But workplace flexibility could have been achieved in other, less costly ways. Besides, the extension of the 35-hour week to the public sector has led to a perceptible degradation in service. That's particularly true in France's once-vaunted health-care system: Doctors work 20% less, on average. Staff shortages in hospitals and nursing homes due to the 35-hour week was a key reason August's heat wave killed 14,000 in France.

Lambert's admission could have been the moment when France's leaders signaled that the country was changing direction. German Chancellor Gerhard Schröder has been much more forthright about

need to become more economically competitive, and the Bundestag is to vote Oct. 17 on a package of economic reforms. In opening up the discussion about the 35-hour week—and then doing nothing about it—France could be blowing another chance for serious reform. ■



France: Fewer Working Hours

Average hours worked per person employed in 2002

France	1,459
Britain	1,707
Japan	1,809*
U.S.	1,815

*2001

Data: Organization for Economic Cooperation & Development

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CHINA

HU JINTAO: CHINA'S GORBACHEV?

There's growing evidence that the new President is starting political change

A MID-AUTUMN fantasy: The year 2012 is drawing to a close, and China is preparing to inaugurate its first democratically elected President. World leaders are gathered in Beijing to congratulate its outgoing leader, Hu Jintao, for paving the way to democracy. Hu got the ball rolling back in 2003. That was the year he took over as President from Jiang Zemin, the year China sent its first astronaut into space, and the year Hu presided at his first annual plenary session of the Communist Party's Central Committee. At that October 11-14 meeting, the 60-year-old Hu pushed through a series of modest changes that created momentum for political reforms that have blossomed into full-fledged democratic institutions.

Sound far-fetched? Certainly. But there is reason to believe that Hu may be unleashing forces that will lead to real reform in China. Like Mikhail Gorbachev during the final days of the Soviet Union, Hu has little reason to dismantle a system

that brought him to the peak. But like Gorbachev, Hu seems prepared to take measures to cure the rot that has eaten away the credibility of the ruling Communists—measures that may eventually cause the system to crumble. “There’s a large sense within Chinese society that China needs political reform,” says David Zweig, a political scientist at Hong Kong University of Science & Technology.

Hu's Checklist

DEMOCRATIC REFORMS Party officials have been encouraged to debate and even critique the work of top leaders. Multicandidate elections, though, are held only in villages and Hu has made no move to expand them to other areas.

BALANCED GROWTH Rather than growth at any cost, he wants to “comprehensively build a well-off society.” That means revitalizing Rust Belt areas, emphasizing job creation, helping the poor rural population, and protecting the environment.

HU IN BEIJING: Moving to recognize the right to private property

True, those wanting quick results have so far been disappointed. The official communique from the plenum didn't mention political reform. Hu has made vague references to democratic elections but done nothing to expand multicandidate polls, which currently exist only for lowest-level leaders in the countryside. And he has shown little tolerance for dissent in the media.

Still, an optimist might see some hopeful signs in the tea leaves. Before the plenum, Hu scored a modest victory getting the Politburo to submit a report to the Central Committee, reestablishing the idea that senior leaders are actually countable—even if only to a group of most-as-senior leaders. That could send the message that officials must be on their toes. Hu has encouraged administrative experiments, such as a Shanghai initiative requiring competition among candidates for many jobs. And the plenum produced a call for a constitutional amendment to recognize the right to private property. While the move was intended to make it easier to privatize state-owned enterprises, it could lead the growing middle class to demand political and legal reforms, says Winston Zhao, a partner at the Shanghai office of U.S. law firm Jones Day. “When you own property, you want to make sure that it is protected and that your representative will voice your concerns,” says Zhao.

AN EXTERNAL JOLT HU MAY BE TEMPTED to mull a breakthrough, in the same way China has delayed decisions on economic issues such as banking reform. An external shock, though, could kick-start political change. A return of SARS, or a more deadly outbreak, could lead to greater dissent. And Hu has to contend with unemployment as high as 10%, a risk for unrest. If large-scale protests were to break out, Hu may not be as willing as Jiang to summon troops. One big reason: A crackdown would jeopardize the 2008 Beijing Summer Olympics, which the government is desperate to pull off without a hitch.

So here's the rest of that fantasy: In 2007, demonstrations erupt nationwide. Instead of suppressing them, Hu negotiates with the protesters in the run-up to the Olympics. After that turning point, the hardliners can only watch helplessly as events move beyond their control. The rest is history. ■

—By Bruce Einhorn in Hong Kong

AT&T Wireless

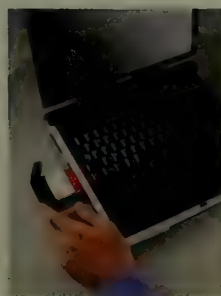
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Color-Shifting Ink

Tilt the bill up and down, and the color-shifting ink in the number "20" in the lower right corner changes from copper to green and back.



EDITED BY ROSE BRADY

Iraq: A U.N. Deal till Won't Pay the Bills

BUSH ADMINISTRATION was on the verge of winning support in the U.N. Security Council for a resolution on Iraq's future. *BusinessWeek* went to press on Oct. 15. Washington hopes a U.N. vote will spur other governments to provide desperately needed troops and financial support for stabilizing

rebuilding Iraq. Indeed, the U.S. tried to push the resolution through at an Oct. 23-24 conference of 60 national donors in Madrid. There, U.S.-appointed Iraqi Governing Council will ask for tens of billions of dollars to repair everything from Iraq's electricity grid to its health system. Was this the breakthrough for the U.S.'s planned postwar effort? Don't bet on it. The conference will be a success, ventures State Dept. official, "if Iraqis walk away with the conclusion that the international community is strongly behind them." But it's not in the cards. True, there are some positive signs. Japan is expected to

pledge \$5 billion over four years, and may send a few hundred peacekeepers. America's coalition partner, Britain, is planning to commit more than \$900 million for reconstruction over the next three years. At least a few other European countries have so far moved forward with their pledges. And the European Union has pledged a mere \$230 million to its stretched budget. Meanwhile, some 30 countries are supplying a total of 22,000 troops. But

that's not much compared with the 100,000 U.S. and British soldiers still on the ground. So far, only Ankara has pledged a major force of 10,000 peacekeepers, despite opposition in Turkey and Iraq. Less than a week after the Turkish Parliament's vote to send the troops, a suicide bomber attacked the U.S. Embassy in Baghdad on Oct. 14. From Islamabad to Berlin, political leaders still find a myriad of reasons to

hold back from committing either troops or funds. Germany and France point to their economic woes, not to mention their opposition to the war. Pakistan has considered sending troops, but only if several Muslim countries do so—an unlikely prospect so far.

Isolationism's High Price

AND THERE REMAIN strong differences over when the U.S. should hand back sovereignty to Iraq. Washington insists on transferring control only after Iraqis draft a constitution and hold elections, which could take at least a year. Other nations, led by France, Russia, and Germany, think

the process should be sharply sped up and overseen by the U.N., not Washington. "The Bush Administration won't consider what the rest of the world wants, which is [for the U.S.] to give up control," says Ivo H. Daalder, a foreign policy expert at Brookings Institution.

The reluctance of other countries to contribute



IRAQ REPAIRS The country may need \$55 billion through 2007

explains why President George W. Bush asked Congress for \$20 billion for Iraqi reconstruction for 2004 alone. But more will be needed. The World Bank and U.N. recently estimated that Iraq requires \$55 billion through 2007. Given the expected outcome in Madrid, Iraqi participants are likely to walk away disappointed—not confident in the international community's support. And Washington will have to shoulder the burden in Iraq for much longer than the Bush team had hoped. ■

—By Stan Crock in Washington, with bureau reports

GLOBAL WRAPUP

SIGNS OF TROUBLE IN SAUDI ARABIA

POLITICAL FRICTION is growing in Saudi Arabia. On Oct. 14, Riyadh witnessed a public demonstration—a rare occurrence in the kingdom, where such displays are illegal. The protesters, Saudis say, included relatives of detained Islamic militants and family members of the roughly 60 youths recently killed in a fire at a Saudi detention center. They are said to have demanded faster reforms and the release of political prisoners. The police carted off dozens of people.

Meanwhile, in a gesture to both the outside world and opinion in the kingdom, the royal family has agreed to hold elections for municipal councils at an unspecified date. Critics welcome the announcement, but it is far from clear that the councils will have real power.

CENTRAL ASIA: ALL IN THE FAMILY

THE EXPECTED victory of **Ilham Aliyev** in Azerbaijan's presidential elections on Oct. 15 could signal the beginning of a wave of nepotism in Central Asia. Aliyev, 42, is son of 80-year-old Heydar Aliyev, who stepped down for health reasons. The opposition and other observers alleged that the election was rigged in the younger Aliyev's favor—a poor omen for democracy if true. Now, some fear that Kazakhstan President Nursultan Nazarbayev, 62, and Uzbekistan President Islam Karimov, 65, may eventually try to hand over power to their children. Nazarbayev's daughter, **Dariga Nazarbayeva**, 40, has created a political party. Karimov's daughter, **Gulnora Karimova**, 31, is adviser to the Uzbek ambassador in Moscow. Both women have already had prominent business careers.

An Inner-City Renaissance

The nation's ghettos are making surprising strides. Will the gains last?

TAKE A STROLL AROUND Harlem these days, and you'll find plenty of the broken windows and run-down buildings that typify America's ghettos. But you'll also see a neighborhood blooming with signs of economic vitality. New restaurants have opened on the main drag, 125th Street, not far from a huge Pathmark supermarket, one of the first chains to offer an alternative to overpriced bodegas when it moved in four years ago. There's a Starbucks—and nearby, Harlem U.S.A., a swank complex that opened in 2001 with a nine-screen Magic Johnson Theatres, plus Disney and Old Navy stores and other retail outlets. Despite the aftermath of September 11 and a sluggish economy, condos are still going up and brownstones are being renovated as the middle classes—mostly minorities but also whites—snap up houses that are cheap by Manhattan standards.

It's not just Harlem, either. Across the U.S., an astonishing economic trend got under way in the 1990s. After half a century of relentless decline, many of America's blighted inner cities have begun to improve. On a wide range of economic measures, ghettos and their surrounding neighborhoods actually outpaced the U.S. as a whole, according to a new study of the 100 largest inner cities by Boston's Initiative for a Competitive Inner City (ICIC), a group founded in 1994 by Harvard University management professor Michael E. Porter.

Consider this: Median inner-city household incomes grew by 20% between 1990 and 2000, to a surprising \$35,000 a year, the ICIC found, while the national median gained only 14%, to

about \$57,000. Inner-city poverty fell faster than poverty did in the U.S. as a whole, housing units and homeownership grew more quickly, and even the share of the population with high school degrees increased more. Employment growth didn't outdo the national average, with jobs climbing 1% a year between 1995 and 2001, vs. 2% nationally. Still, the fact that inner cities, which are 82% minority, created any jobs at all after decades of steady shrinkage is something of a miracle.

SCENT OF OPPORTUNITY

NOR ARE THE GAINS just the byproduct of the superheated economy of the late 1990s. Rather, they represent a fundamental shift in the economics of the inner city as falling crime rates and crowded suburbs lure the middle-class back to America's downtowns. After decades of flight out of inner cities, companies as diverse as Bank of America, Merrill Lynch, and Home Depot have begun to see them as juicy investment opportunities. National chains are opening stores, auto dealerships, and banks to tap into the unfulfilled demand of inner cities.

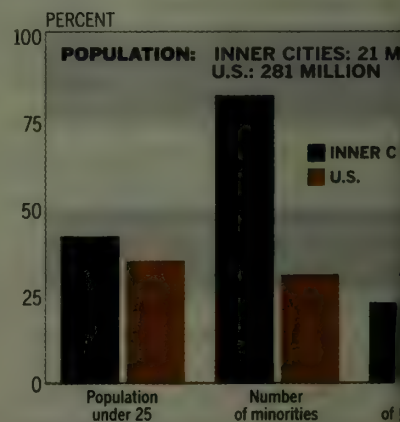
Wall Street, too, is jumping in, making loans and putting up equity for local entrepreneurs. "Smart businesspeople gravitate toward good opportunities, and it has become clear that inner



cities are just that," says David W. Traub, chairman of Merrill Lynch & Co.'s Business Financial Services group. In 2001, his group, which caters to small business, began formally targeting inner cities and now offers financing and commercial mortgages for hundreds of inner-city entrepreneurs around the country.

Inner Cities and Their Residents...

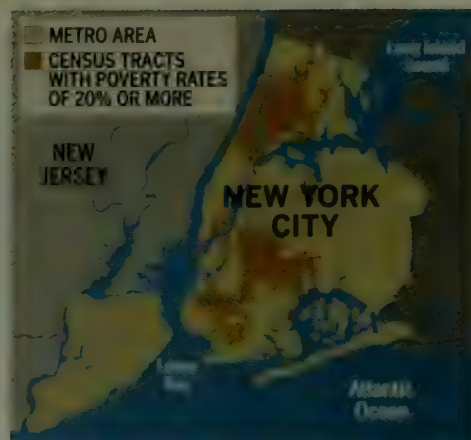
The Boston-based Initiative for a Competitive Inner City has completed the first-ever analysis of the 100-largest inner cities in the U.S. and finds the once-dismal picture brightening



Data: Initiative for a Competitive Inner City



HARLEM 125th Street is sprouting new stores and restaurants



ence of long-term trends is likely to continue to lift inner cities for years. The falling crime rate across the country has been a key factor, easing fears that you take your life in your hands by setting foot in an inner city. At the same time, larger demographic shifts—aging boomers turned empty nesters, more gays and nontraditional households without children, homeowners fed up with long commutes—have propelled Americans back into cities. When they arrive, slums suddenly look like choice real estate at bargain prices.

BEYOND PHILANTHROPY

POLITICAL AND CIVIC leaders helped lay the groundwork, too. After floundering for decades following the exodus of factories to the suburbs in the 1950s, many cities finally found new economic missions in the 1990s, such as tourism, entertainment, finance, and services. This has helped boost the geographic desirability of inner-city areas. New state and federal policies brought private capital back, too, by putting teeth into anti-redlining laws and by switching housing subsidies from public projects to tax breaks for builders. As a result, neighborhoods like the predomi-

nantly African-American Leimert Park in South Central Los Angeles are becoming thriving enclaves.

The outcome has been a burst of corporate and entrepreneurial activity that already has done more to transform inner cities than have decades of philanthropy and government programs. "What we couldn't get people to do on a social basis they're willing to do on an economic ba-

it possible that America at last has ed to solve one of its most intractable d ills? True, the progress so far is m- iple compared with the problems cre- by decades of capital flight, abysmal ols, and drug abuse. And some inner s, like Detroit's, have made little sus- ed progress. Ghettos also have been

hit by the joblessness of this latest recovery. The national poverty rate has jumped by nearly a percentage point since 2000, to 12.1% last year, so it almost certainly did likewise in inner cities, which the ICIC defined as census tracts with poverty rates of 20% or more.

But as the economy recovers, a conflu-

And Better than the Nation as a Whole in the 90s...

Change between 1990 and 2000 Census data

	INNER CITIES	U.S.
Unemployment	24%	13%
Median income	20%	14%
Population growth	20%	13%
High school graduates*	55 to 61%	75 to 80%
College graduates*	10 to 13%	20 to 24%
Home ownership	29 to 32%	64 to 66%
Poverty rate	34 to 30%	13 to 12%

...Although There's Still A Long Way to Go

2000 Census data

	INNER CITIES	U.S.
High school graduates*	61%	80%
College graduates*	13%	24%
Poverty rate	31%	11.3%
Unemployment rate	12.8%	5.8%
Home ownership rate	32%	66%
Average household income	\$34,755	\$56,600
Aggregate household income	\$250 billion	\$6 trillion

Data: Initiative for a Competitive Inner City



sis," says Albert B. Ratner, co-chairman of Forest City Enterprises Inc., a \$5 billion real estate investment company that has invested in dozens of inner-city projects across the country.

EMERGING MARKETS

THE NEW VIEW OF GHETTOS began to take hold in the mid-1990s, when people such as Bill Clinton and Jesse Jackson started likening them to emerging markets overseas. Porter set up the ICIC in 1994 as an advocacy group to promote inner cities as overlooked investment opportunities. Since then, it has worked with a range of companies, including BofA, Merrill Lynch, Boston Consulting Group, and PricewaterhouseCoopers to analyze just how much spending power exists in inner cities.

The new study, due to be released on Oct. 16, uses detailed census tract data to paint the first comprehensive economic and demographic portrait of the 21 million people who live in the 100 largest in-

ner cities. The goal, says Porter, "is to get market forces to bring inner cities up to surrounding levels."

Taken together, the data show an extraordinary renaissance under way in places long ago written off as lost causes. America's ghettos first began to form early in the last century, as blacks left Southern farms for factory jobs in Northern cities. By World War II, most major cities had areas that were up to 80% black, according to the 1993 book *American Apartheid*, co-authored by University of Pennsylvania sociology professor Douglas S. Massey and Nancy A. Denton, a sociology professor at the State University of New York at Albany. Ghettos grew faster after World War II as most blacks and Hispanics who could follow manufacturing



jobs to the suburbs so, leaving behind the poorest and most unemployable. Immigrants poured in, too, although most tended to leave when they assimilated.

In this context, the city is solid gains the 1990s represent an extraordinary shift in fortunes. On the biggest change has come in housing. As cities have become

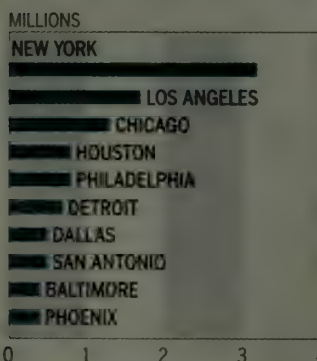
desirable places to live again, the number of inner-city housing units jumped 20% in the 1990s, vs. 13% average for U.S. as a whole.

A number of companies were quick to see the change. BofA, for example, developed a thriving inner-city business since it first began to see ghetto growth market six years ago. In 1995, it pulled together a new unit called C

BENCHMARKS OF PROGRESS

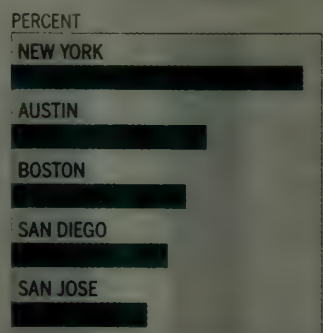
How Big

INNER-CITY POPULATION IN 2000



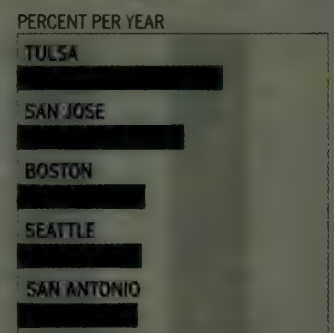
Grand Opening

TOP 5 INNER CITIES WITH MOST NEW BUSINESSES, 1995-2001



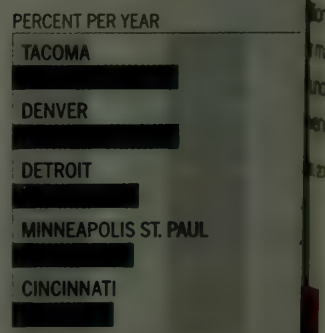
Help Wanted

TOP 5 INNER CITIES WITH MOST JOB GROWTH, 1995-2001



Fatter Wallets

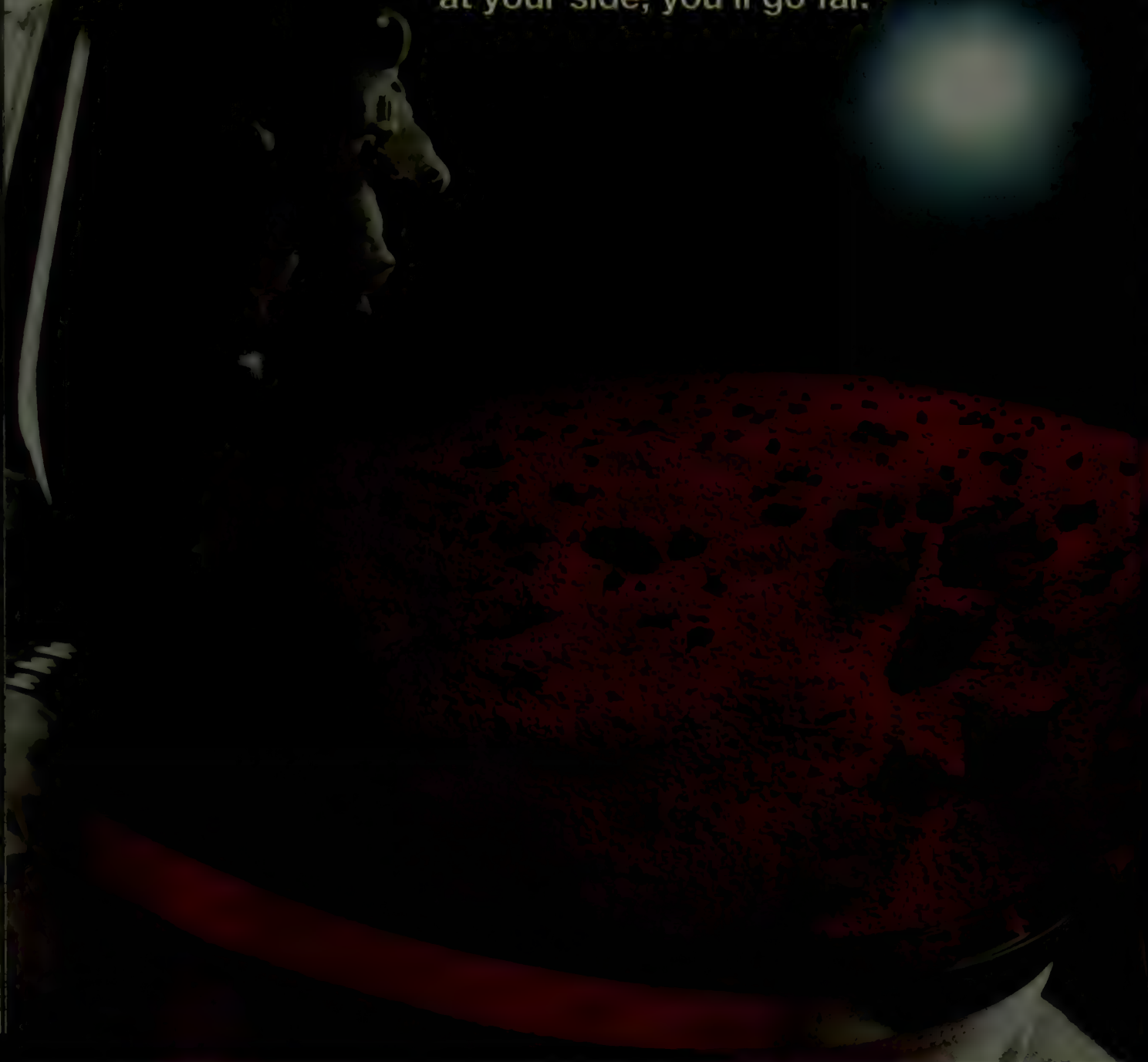
TOP 5 INNER CITIES WITH FASTEST INCOME GROWTH, 1995-2001*



*OF INNER CITIES WITH AT LEAST 100,000 RESIDENTS

Data: Initiative for a Competitive

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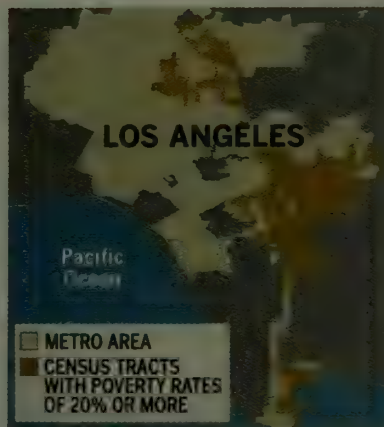
LOS ANGELES In South Central, Leimert Park is a thriving neighborhood

munity Development Banking, which focuses primarily on affordable housing for urban, mostly inner-city, markets, says CDB President Douglas B. Woodruff. His group's 300 associates are on track this year to make \$1.5 billion in housing loans in 38 cities, from Baltimore to St. Louis. They will do an additional \$550 million in equity investments, mostly real estate.

SHELLED OUT

PENSION FUNDS AND other large investors are putting in cash, too. The Los Angeles County Employee Retirement Assn. has sunk \$210 million into urban real estate since 2000, including \$87 million in August for a bankrupt, 2,496-room apartment complex in Brooklyn, N.Y. The plan is to do things like fix the broken elevators, hire security guards, and kick out nonpaying tenants. "We believe there are opportunities that weren't there before or that we weren't aware of," says board member Bruce Perelman.

One question is whether the ICIC's findings represent not so much progress by the poor as their displacement by middle-class newcomers. In other words, inner-city incomes could be rising simply



because affluent new home buyers jack up the average. But experts think gentrification explains only a small part of what's going on. "It's certainly a local phenomenon, but if you aggregate 100 inner cities, gentrification is a small trend," says ICIC research director Alvaro Lima, who spearheaded the study.

In Chicago, for instance, a \$65 million redevelopment of the notorious Cabrini-Green housing project has replaced three slummy high-rises with mixed-income units. The area has a new library, new schools, and a new retail center featuring a major grocery store, Starbucks, and Blockbuster—all staffed by scores of local residents. "The goal is not gentrification, it's to integrate the classes," says Phyllis L. Martin, the head of a local committee that's trying to lure more than \$50 million in private capital to help the city replace 3,245 public housing units in another blighted area, Bronzeville.

Despite the brightening picture, the decay of most inner cities is so advanced that half a dozen years of progress makes only a dent. The degree of poverty—a measure of how many poor people there are in a census tract—fell 11% in 60 large cities in the 1990s, according to an

analysis by U Per Massey that parallels ICIC's approach. What's that a significant decline it only begins to offset doubling of poverty concentrations in past decades, he found. "The gains are the first positive news since at least the 1950s, but we're just beginning to undo all the damage," says Massey.

BADGE OF SHAME

WHAT'S MORE, too many inner cities remain untouched. More than a third of the ICIC's 100 cities lost jobs between 1995 and 2001. Detroit's ghetto, seen little new development and shed one-fifth of jobs over this period. I

dents did gain from the booming auto industry, which hired many locals and pushed up their median incomes at a 3.2% annual pace in the 1990s—the highest increase of the ICIC 100. But as auto makers now shedding jobs, those gains are likely to be short-lived. More broadly, improving inner cities won't come close to wiping out poverty in the U.S. While the inner-city poverty rate of 31% is nearly three times the national average, the 6.5 million poor people who live there represent less than a fifth of the country's 34.6 million poor.

Still, America's ghettos have become a national badge of shame for so long that any real gain is news. The change in perspective also seems to be an enduring one, not just a 1990s blip. For evidence, consider Potamkin Auto Group, which

owns 70 dealerships around the country and will break ground in Harlem in October on a \$50 million development that will include Cadillac, Chevrolet, Lincoln, and Saturn dealerships. Potamkin also has a presence in another inner city, where it is mulling a national expansion. "We see opportunities there," says R

Potamkin, president of the family-owned company. This view, that inner cities can be a good place to do business, may be the most hopeful news about the country's urban blight in decades.

—By Aaron Bernstein in Washington with Christopher Palmeri in Los Angeles and Roger O. Crockett in Chicago

"We're just beginning to undo all the damage"

BusinessWeek online For more on inner cities, go to <http://www.businessweek.com/magazine/extra.htm>

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Is Viagra Vulnerable?

Eli Lilly's Cialis lasts for 36 hours—and a \$100 million ad blitz will spread the word

PAULA GARRETT KNEW she had a winner a year ago. The marketing executive for Eli Lilly & Co. was gauging consumer reaction to a yet-to-be released drug aimed at treating erectile dysfunction. The lights went back on in a conference room where three women had been viewing a prospective TV commercial for the drug, which Lilly had dubbed Cialis. The focus-group members, whose husbands all suffered from impotence, had watched attentively as a male voice-over gently advised: "Introducing Cialis. You can take Cialis anytime and have up to 36 hours to respond to your partner, without planning or rushing." As Garrett observed from the other side of a one-way mirror, the group's moderator tried to suss out the main source of the women's interest. "Tell me specifically," she asked. "What is it you like about Cialis?"

Suddenly, one of the women leaped out of her chair. She was about 60 years old

and seemed as straitlaced as a Sunday school teacher. "Thirty-six hours!" she whooped, raising her arms like she was doing the wave at a ballgame. "Yeah!"

Garrett recalls laughing with delight. In her 15-year career in brand marketing, she has monitored hundreds of focus groups, for Procter & Gamble, Coca-Cola, and, since early 2001, Lilly as U.S. consumer marketing manager for Cialis. Yet



she says she can't recall ever seeing anyone get this excited about a product. "It was a marketer's dream," she says.

Just how good a dream Lilly will discover soon. Sometime in the next several weeks, Lilly and its joint-venture partner biotech lab ICOS Corp., expect to get final approval from the Food & Drug Administration to sell their Viagra slayer, Cialis, in the U.S. An ad campaign expected to cost at least \$100 million in its first year will follow within days. There's a lot riding on Lilly's ability to turn Cialis (the name derived from the French "ciel," or sky) into a billion-dollar drug. Lacking new hits since Prozac lost its patent protection in mid-2001, the Indianapolis drugmaker expects its earnings to drop 2003 for the third year in a row, to more than \$2.66 billion. And it is eager to turn around a stock that has sagged 25% over the past two years, to \$63 a share.

SOMETHING DIFFERENT

THE LAUNCH ALSO WILL be the first test of whether Lilly, which has never attempted a mass direct-to-consumer campaign in the past, has mastered the marketing skills needed to compete in today's hypercompetitive drug market. The challenge for drugmakers is not much different from that confronting marketers of breakfast cereal, detergent, or soft drinks: Take a product that is fairly similar to those of rivals and find some point of difference that is meaningful—can be made to seem meaningful—to potential buyers. In this case, the edge is that Cialis lasts for up to a day and a half while competing brands are potent only four hours.

Lilly executives, of course, believe they have succeeded, which is why they were willing to give *BusinessWeek* a peek at the strategy they crafted the marketing plan for Cialis. They've been buoyed by the drug's success in Europe, Saudi Arabia, Brazil, and other markets. It had first-half sales of \$58.9 million, passing Viagra in wholesale pharmacy orders in France and Italy. Analyst C. Anthony Butler of Lehman Brothers Inc. expects global sales for Cialis to hit \$300 million in 2004 and as much as \$2 billion six years out. Declares Lilly Chairman and CEO Sidney Taurel: "It's a blockbuster drug."

To get there, Lilly must best some fierce competition. Already, rivals are suggesting to doctors that while Cialis

CHEERLEADER

Garrett is leading the charge

may last longer, it also prolongs the side effects that some users experience with impotence drugs

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headaches, muscle aches, and nausea. The world's No. 1 drugmaker, Pfizer Inc., proved its marketing mastery with the first ads for Viagra in 1998. That campaign, built around testimonials by Bob Dole appealing mostly to older men, took the problem of erectile dysfunction out of the realm of the taboo. Today, Viagra ranks with Coca-Cola among the most widely known consumer brands in the world, with sales approaching \$2 billion.

THE DROPOUTS

IT'S NO WONDER everyone knows Viagra—Pfizer spent \$87.3 million last year to advertise Viagra in the U.S. alone, says TNS Media Intelligence/CMR. And the market leader is ready to buy more TV time and ad pages to stay on top, says Janice Lipsky, Viagra's U.S. team leader. Concedes Leonard M. Blum, ICOS vice-president for sales and marketing: "There aren't many examples in our industry of products launched in second or third position that end up becoming the leader. It's a tall order."

Adding to Lilly's challenge, Cialis has been beaten to the U.S. market by Levitra, which is being pushed by a 50-50 part-

nership of GlaxoSmithKline PLC, the industry's No. 2 player, and Bayer. Employing TV ads that promise the virility of a professional athlete, those companies have redefined erectile-dysfunction pills into something approaching a lifestyle drug. Already, after just two months of marketing, doctors say many men are asking specifically for Levitra. The drug grabbed 13% of new erectile-dysfunction prescriptions in September, according to market researcher IMS Health Inc.

Stepping into this brawl, Lilly executives knew they could leave nothing to chance. The Cialis campaign got started in mid-2000, a full year before large-scale clinical testing of the drug had even been completed. Lilly embarked on a monumental research effort, parsing reams of market data and quizzing thousands of men suffering from impotence and their partners. The data pointed to some significant opportunities. While Pfizer's marketing juggernaut had persuaded more than 16 million American men to try

Rivals say side effects may last 36 hours, too

Viagra, that was barely half the estimated 30 million who suffer at least some sexual dysfunction. Reach those other 15 million, it was clear, and you could develop a substantial business even if you did steal a single user from Viagra.

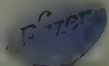
There was more. Of those 15 million men who had tried Viagra, more than half hadn't renewed their prescription. That's a much higher drop-

rate than with most drugs. To Garre's marketing team, that suggested that Viagra was indeed vulnerable.

Meanwhile, an intriguing development was emerging from the lab. While Cialis, Viagra, and Levitra all work on the same principle—they are so-called PDE5 inhibitors, which make muscles in the penis relax and allow increased blood flow for an erection—some crucial differences were showing up in clinical trials. For one, unlike Viagra, Cialis remained effective even if the user ate or had a drink. That provided an edge, albeit a modest one, because Levitra offered the same advantage. More promising was that while both Viagra and Levitra enabled men to have an erection anytime from a half hour to 4 hours after swallowing the pill, Cialis expanded that window to 36 hours. Would consumers perceive that to be a valuable benefit to their mating ritual? The answer seemed clear enough from the reaction of focus-group participants.

Putting **Pop** in Their Pills

To compete in the crowded impotence-drug market, manufacturers are playing up any product difference

	 VIAGRA	 LEVITRA	 CIALIS
U.S. INTRO	April, 1998	August, 2003	Expected by yearend
MAKER	Pfizer	Bayer and GlaxoSmithKline	Eli Lilly and ICOS
PRODUCT CLAIM	Works within a half-hour, lasts 4 hours	Works within a half-hour, lasts 4 hours; not affected by food or alcohol	Works within a half-hour, lasts 36 hours; not affected by food or alcohol
KEY MESSAGE	Safe, reliable. The drug you can trust.	It's new. It's hot. It'll make you hot, too.	What's the hurry? Take your time.
AD TAGLINE	"Join the millions."	"Once you get in the zone, it's good."	"At the right moment, you'll be ready."
MACHO SPOKESMAN	Baseball player Rafael Palmeiro	Retired football player and coach Mike Ditka	None planned
SPORTS TIE	Major League Baseball	National Football League	Professional Golf Assn.

TARGETING ROMANTICS

WITH A PROMISING POINT of difference uncovered, the next challenge was how to communicate it to consumers amid the marketing din emanating from Viagra and Levitra. From their very first sessions with patients, Lilly's market research detected sharp differences in the way men perceived Cialis and Viagra. In one-on-one interviews in mid-2000, Viagra users who had been informed of the attributes of both drugs were given a stack of objects and asked to sort them into groups, one for Viagra and the other for Cialis. Red-lace teddies, stiletto-heeled shoes, and champagne glasses were signed to Viagra, while fluffy bathrobes and down pillows belonged to Cialis. The implication: Viagra was for studs, Cialis for romantics.

The dichotomy was reinforced in one-on-one sessions with partners of men with impotence problems. With Viagra, women often confessed, they felt under the gun to perform. "It feels like there are three of us in bed," marketing managers

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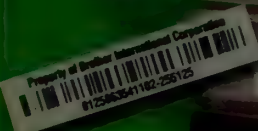


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Marketing

Garrett recalls one saying. "Me, him, and the pill." On the other hand, women typically said that from what they had heard about Cialis, they could be more natural and wait to have sex until both of them were in the mood. With each session, Garrett and her colleagues grew surer that they had a message consumers would warm to.

Following hundreds of patient and partner interviews, focus groups, and polling, Lilly and its ad agency, Grey Worldwide, got down to devising advertising strategies. Given a real product difference to flog, none of the approaches took the celebrity-spokesman route. "What we want is just to lay the facts on the table, because the facts are very friendly in our case," says Lilly's U.S. team leader for

Cialis, Matthew W. Beebe. Agency and client eventually narrowed the proposals down to three and produced TV spots for each in early 2002. Two were variations on the theme, "Choose the moment." The third was based on the old hit song by The Supremes, *You Can't Hurry Love*.

A JAZZ SOUNDTRACK

AFTER FURTHER CONSUMER research, though, *You Can't Hurry Love* was rejected. By tying Cialis to one song, Lilly's market researchers concluded, they would never be able to alter the pitch even after consumers got tired of it. Instead, they opted for an ad with scenes of couples snuggling and slowly caressing, to emphasize cozy, tender, or playful moments. A soundtrack of easy, laid-back jazz seemed to work best. Garrett's final tweak was to lengthen scenes in the ad so the camera now seems to linger with each couple, a subtle reminder that with Cialis there's no hurry. The tagline:

**Lilly's ad
team
feels a
sports
star isn't
needed**

THE HEAT IS ON

With both its earnings and stock price in a slump, Lilly needs a fast start for Cialis, its new erectile-dysfunction drug

CHANGE IN EARNINGS SINCE 2000

-13%

CHANGE IN STOCK PRICE
SINCE OCT. 14, 2001

-21%

Data: Eli Lilly & Co.

"When a tender moment turns into the right moment, you'll be ready." The spots will saturate prime-time shows and weekend sportscasts almost as soon as FDA approval is obtained. "You won't be able to turn on your TV without seeing ads," says ICOS' Blum.

DUELING LUNCHES

BUT AS LILLY waits, rivals are not standing still. They're ratcheting up their own spending even as their thousands of sales reps work hard to develop Cialis' strategy. The reps are warning doctors—often while showing expensive meals paid for by the reps—that while Cialis may be potent for as long as 36 hours, the drug's side effects might last that long, too. They also insist their own research shows that

most men with impotence know what to do ahead of time when they might have a moment, so the four hours that Viagra or Levitra provides them is usually sufficient.

Some doctors, such as Steven J. DeGeles, are proving receptive to the counterattack. "You could have 36 hours of misery," says the Chicago internist whose office staff has been taken out of lunches costing more than \$3,000 apiece by teams hawking Viagra and Levitra. Besides, he adds, unless they're going to be hopping, men generally don't need too much time. DeGeles says he was won over by the marketers' arguments, not gratis wining and dining. Lilly and ICOS hint that they'll use similar tactics to reach doctors once Cialis is approved.

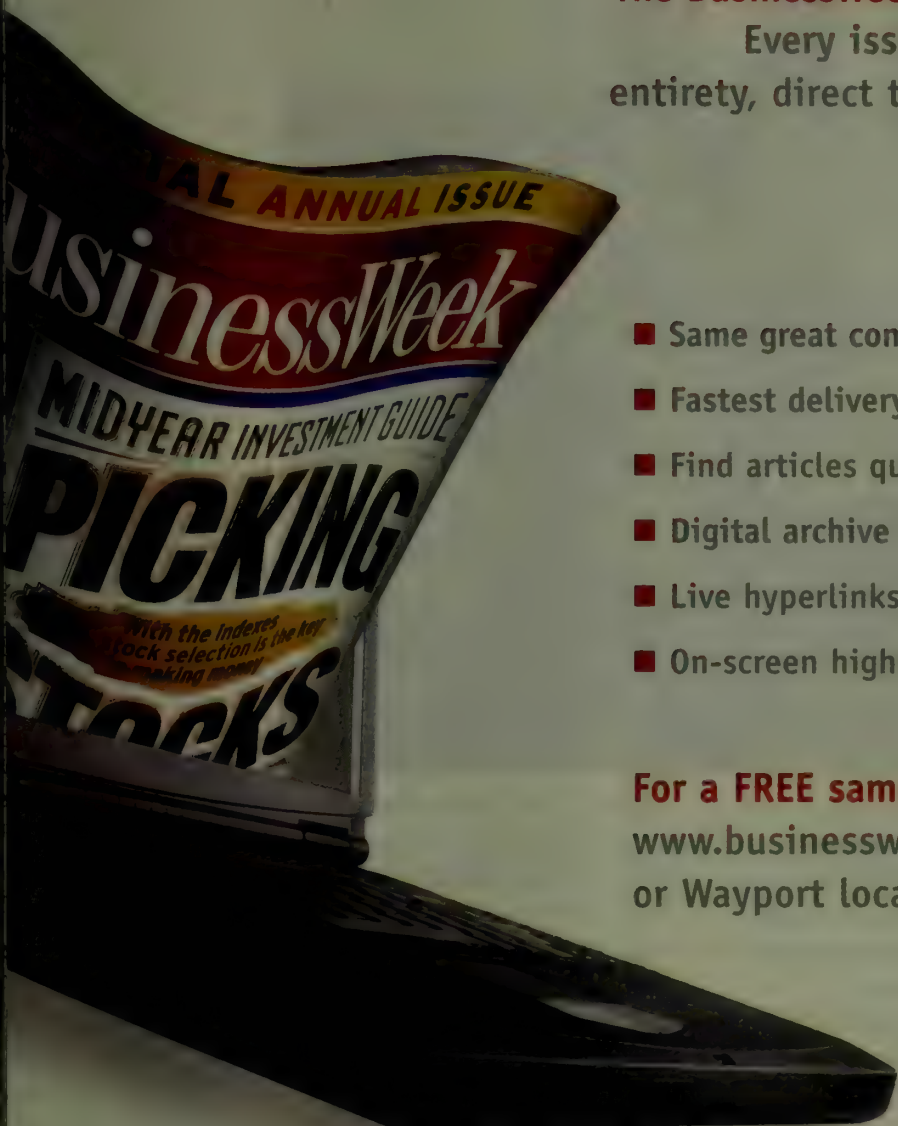
Of course, from Lilly's perspective, resistance from doctors makes it even more important that its ad campaign capture the attention of consumers. Company executives are confident that the message will cut through the clutter, proving that Lilly belongs with Pfizer and GlaxoSmithKline in the ranks of ad consumer marketers. If they're right, consumers won't be the only ones whooping it up. Lilly's shareholders have a reason to do the wave, too. ■

—By Michael Arndt in Indianapolis

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The New Outsourcing

FROM OUTSOURCING TO OUTCOMPETING

Sure, outsourcing can reduce costs. But can it also enable you to outmatch your rivals? Discover how smart companies are using outsourcing for competitive advantage.



In today's business environment, just about every company is looking for ways to reduce costs. And organizations have long recognized that outsourcing can be an effective weapon in the cost-cutting arsenal. In fact, more than one-third of companies that outsource information technology do so for cost savings, according to IT Toolbox, a research firm.

But outsourcing is about more than shrinking budgets. Pursued strategically, outsourcing can deliver a broad range of advantages. Progressive companies are using outsourcing to:

- Benefit from best practices
- Focus on core competencies
- Adapt to changing market conditions
- Rethink and actually transform the business

In short, companies are applying outsourcing as a strategic mechanism for becoming more competitive in the marketplace.

PART OF THE PROCESS

What's appropriate for outsourcing? Anything that's not core to your business or related to your strategic direction. In general, functions that affect revenue generation, such as product development and direct customer contact, are core. Anything that's not core, though, is simply "context"—necessary for doing business, but not strategic.

In the past, outsourcing targeted clearly definable functions. In IT, for example, activities like help desk, security, and backup and recovery are ideal candidates for outsourcing. But forward-

thinking companies have discovered effective ways of outsourcing entire functions. Such business process outsourcing (BPO) can include financial, accounting, payroll and benefits management, and even some aspects of customer care.

In fact, the BPO market is expected to grow nearly a 10 percent annual rate, reaching \$173 billion by 2007, according to Gartner, a research firm. Outsourcing will expand more slowly, from \$5.

billion to \$707 billion during the same period.

The National Cancer Institute was a BPO pioneer 10 years ago when it tapped Science Applications International Corporation (SAIC) to manage its labs and research facilities, plus more than 1,600 of its people, including doctors, scientists and researchers. "We have special knowledge and expertise in science and engineering that customers don't have, that we can provide through business process outsourcing," says Randy Walker, corporate executive vice president of commercial and international business for SAIC.

It's the same reason organizations turn to outsourcers like Penske Logistics, which provides supply chain services to help companies cut costs, reduce cycle times and improve service. "Companies that hire us find over time that our solutions help them use their supply chains to gain a competitive advantage, as well as realize significant cost savings — providing more value to the shareholders," points out Vincent Hartnett, president of Penske Logistics.

BEST PRACTICES MAKE PERFECT

In addition, business process and other kinds of outsourcing enable companies to take advantage of best practices. An oil and gas company, for example, might be expert in exploration and refining. But why shouldn't it outsource financial accounting, say, to a company that has invested in developing expertise in that function?



a higher plane
of communication

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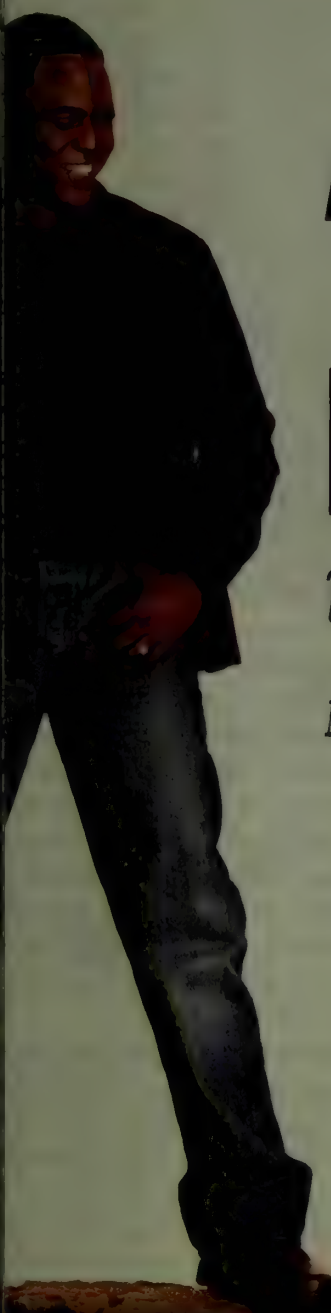
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that we can provide through business
process outsourcing."**

Randy Walker, Corporate
Executive Vice President,
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PUTTING A FACE ON BPO

Human resources is one of the fastest-growing areas of business process outsourcing (BPO). In fact, nine out of 10 CFOs cite HR as the second most likely area to outsource, after IT, according to a study by Hewitt Associates, Inc., an outsourcing and consulting firm.

"HR leaders are under tremendous pressure to manage costs and provide more services," says Bryan Doyle, global business leader of HR and benefits outsourcing services for Hewitt. Because providing more services can require costly investments in technology, outsourcing often becomes an imperative.

Hewitt's HR offerings fall into three categories: payroll, employee benefits and work-force management. The outsourcer leverages technology to manage day-to-day changes in new hires, promotions, transfers and compensation. Hewitt typically loads all of a client's data onto its own computers. Employees then have 24/7 access to information through a call center or a self-service Internet portal.

Companies are often more than happy to offload the complexity of HR administration. One of Hewitt's multinational clients has 200 different HMOs and 400 varieties of health plans. Now, that complexity is Hewitt's headache, and the customer can focus on its core business.

Large IT service providers such as IBM, HP and Unisys allow organizations to offload a portion of their IT infrastructure or even their entire data center. These providers invest in state-of-the-art hardware, software and security, and spread those costs across multiple customers. They can also attract and retain the best talent, and keep staff trained on the latest technology. By outsourcing to such providers, you can scale operations up or down as needed while avoiding risks associated with managing your own resources.

For example, Avaya Inc., a provider of voice and data networks, can run all or part of a customer's communications and information systems. The company designs, builds and manages communications networks for more than 90 percent of the world's largest companies. In addition to reducing costs, Avaya promises to enhance performance and reduce management headaches for organizations that need to integrate a complex mix of voice and data networks. Avaya also walks the walk: the company outsources pension management and related activities to service providers that specialize in HR.

CUT TO THE CORE

Outsourcing is also acknowledged as an effective way to free a company from routine administrative tasks to focus on core competencies and strategic initiatives. In fact, companies are using outsourcing as much to sharpen focus as to cut costs, according to a recent survey by The Outsourcing Institute.

Sharpening focus was the challenge presented to John Wilder, executive vice president and CFO of Entergy Corp., a major

energy company. As Wilder explains, his boss challenged him to take on noncore tasks and businesses and sell them, set up joint ventures, or outsource them. As part of that initiative, Entergy turned to SAIC, which assumed responsibility for a wide array of Entergy's IT functions. Those functions include data center operations, operations and support of distributed servers, desktop support, telecommunications and field services, plus application development, support and maintenance.

With more than 40,000 employees in 150 cities worldwide, SAIC experienced in taking on such large projects. The company even had 500 employees in Iraq rebuilding the

country's telecommunications and oil field infrastructure and training local police.

ADJUST, ADJUST

Entergy, meanwhile, is now better able to focus on electricity power production, retail energy distribution and gas transportation. What's more, the company reports that outsourcing has enabled it to more rapidly respond to changing business needs, deliver more responsive customer service and adapt to changing regulations.

The relationship has also meant flexibility and opportunity for Entergy employees. When SAIC took control of Entergy's operations, 800 affected employees had the choice of remaining at Entergy's payroll or transferring to SAIC. The integration of Entergy and SAIC operations went smoothly, says Wilder, and Entergy's retention rate for IT talent actually increased from about 80 percent to more than 95 percent.

Since outsourcing, Entergy has enjoyed numerous additional benefits, including faster help-desk response and improved system uptime. And the company anticipates continued success. "We just extended the contract for more years, and the scope expanded to human resources and its retail networks, such as its call centers," SAIC's Walker reports.

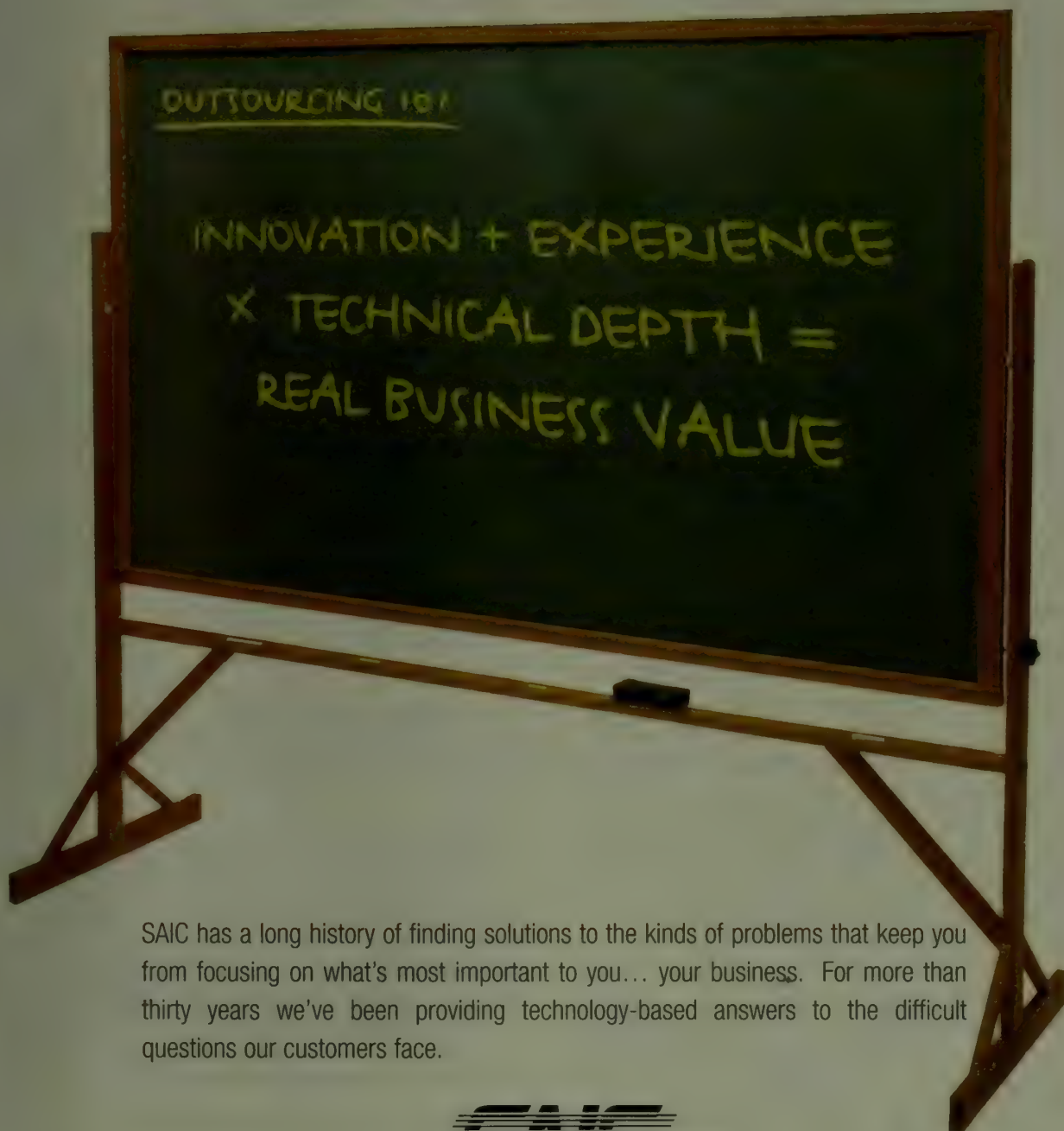
FROM HERE TO TRANSFORMATION

Finally, smart companies are using outsourcing as a way to transform the business and succeed in new competitive environments. Companies are taking advantage of new outsourcing models and collaborative partnerships

**RANDY WALKER, CORPORATE EXECUTIVE VICE
PRESIDENT, SAIC.**



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SAIC has a long history of finding solutions to the kinds of problems that keep you from focusing on what's most important to you... your business. For more than thirty years we've been providing technology-based answers to the difficult questions our customers face.



THE EXPERTS OF CHOICE IN THE SCIENCE OF BUSINESS

"HR leaders are under tremendous pressure to manage costs and provide more services."

Bryan Doyle, Global Business Leader, HR and Benefits Outsourcing Services, Hewitt Associates, Inc.

BPO FOR BEAN COUNTERS

Financial accounting is an increasingly common target for business process outsourcing (BPO). Processes such as general ledger, accounts payable, accounts receivable, fixed assets, billing and payroll can all be appropriate for outsourcing.

Some companies approach this incrementally, simply expanding their bank's role in the processing of accounts payable and accounts receivable. In-house staff still make the decisions, but the bank prints and mails invoices and checks, say, or handles electronic funds transfer. Other companies, especially small and midsize businesses, have found success by outsourcing a greater portion of the accounting function.

Exostar, an electronic marketplace for the aerospace and defense industry, outsources most of its financial accounting to CoEfficient Back Office Solutions. Exostar's books are managed on CoEfficient's systems; payments are received at a bank lockbox and reported to CoEfficient for posting. The arrangement enables the \$9 million Exostar to maintain an internal finance team of just four, including the CFO.

with outsourcers to drive strategic business change. In short, outsourcing is transitioning from a tactical means of controlling costs to a strategic mechanism for executing business strategy.

With this new approach, outsourcing is less a way of controlling change and more a means of managing uncertainty. By focusing on greater flexibility and shared risk, companies and their outsourcers can rapidly respond to changing market dynamics. It's no wonder, then, that the decision to outsource is increasingly being made in the boardroom. It also requires that stakeholders from across the organization be involved to ensure that outsourcing decisions are aligned with overall corporate strategy.

For outsourcing to deliver such transformational value, you and your outsourcer need to work together as partners. Both parties should benefit from the relationship, and both should work toward mutual goals. That often requires a close cultural fit between the two organizations.

ACROSS THE BORDER

Cultural fit can become a challenge when outsourcing to a service provider in another country. That's one of several factors that may temper growth in offshore outsourcing, in which processes are offloaded to providers in low-cost markets such as India and China. These markets have become attractive for IT outsourcing in particular. Offshore, outsourced IT labor rates can be one-half domestic in-house rates, according to AMR Research.

But offshore outsourcing is not without risks. Experts advise companies to develop project management expertise to ensure an effective working relationship with local resources. In addition, the tasks being outsourced must be fully understood by both the outsourcer and internal staff. Other issues that can affect

offshore outsourcing include political unrest and security concerns.

Still, one-fifth of Global 1,000 companies are engaging in offshore IT outsourcing, reports AMR Research. And more than one-third of all organizations are expected to outsource some piece of their IT function to offshore resources within the next year.

Whether working with a service provider in another hemisphere or another city, for a growing number of organizations, outsourcing is delivering on its promise. In addition to controlling costs, outsourcing is enabling companies to take advantage of external expertise, enhance core business, become more adaptable and transform the way they do business. Smart companies have learned that they can't cut their way to greatness. But they can outsource their way to competitive advantage. ■

THE OUTSOURCING INSTITUTE



FRANK CASALE
FOUNDER AND CEO
THE OUTSOURCING
INSTITUTE

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EDITED BY OTIS PORT

INNOVATIONS

Up from the farm —and the sea

» DuPont and the Energy Dept. are funding a drive to create an efficient "bio-refinery" that would enable crops to compete commercially with petroleum. Sugar from corn kernels would be turned into various chemicals, and the rest of the plant would be used to make fuel-grade ethanol and generate electricity.

» Speaking of corn, there could soon be a lot more of it. A **Purdue University** team led by Gurmukh S. Johal (photo) says it found the genetic mechanism that prevents crop plants from growing tall. Dwarf forms of plants typically produce more grains



than tall ones, so cultivating such forms could improve global food supplies, says a report in the Oct. 3 *Science*.

» Sonar may be causing whale suicides. Autopsies of 10 beached whales in the Canary Islands found bubbles in their livers and kidneys resembling those in people with decompression sickness (the bends), reports the Oct. 9 *Nature*. The bubbles may have formed when the whales shot to the surface to escape a cacophony of sonar signals from a nearby naval exercise.

MATERIALS

THESE GLASS GEMS SHOULD HELP LASERS SPARKLE

DIAMONDS MAY BE a girl's best friend, but for lasers, it's rubies and sapphires. Now, scientists at **Containerless Research Inc.** have a new glass that may replace those gems.

Glass is usually lumpy at the atomic level. But by cooling liquid glass very quickly, CRI achieves a more uniform distribution of atoms, allowing the addition of rare-earth elements such as erbium and ytterbium. These boost a laser's efficiency by 20% over ruby or sapphire devices—

at a fraction of the cost.

To make the first batches of this glass, ingredients were levitated with static electricity in a special tool at NASA's Huntsville (Ala.) facility (picture). This kept the drops from being contaminated by atoms on the surface of a container. The researchers have since learned how to cast the glass into rods, which are cut into disks for lasers. A possible application: Lasers for surgery.

—Michael Arndt

SECURITY

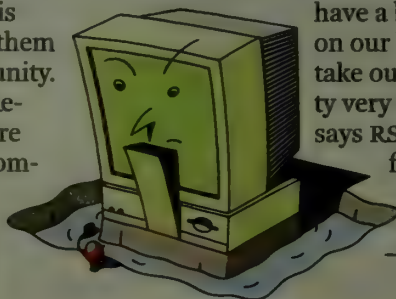
A BOOSTER SHOT FOR THE NETWORK

ANIMALS PRODUCE antibodies to fight off viruses, but computer networks don't. So Steven Hofmeyr, founder of **Sana Security**, is trying to give them artificial immunity. His Primary Response software studies how computers on a network normally behave,

then sounds an alert when it spots unusual activity. It can also block attacks without stopping regular work. Sana has signed up some heavy hitters. It recently licensed the program to **RSA Security**, which helps other companies authenticate computer users. RSA will use the program to guard its own network. "We

have a big bull's-eye on our back and take our own security very seriously," says RSA Chief Information Officer Gerry Wilson.

—Neil Gross



TRANSISTORS

NANOCHIPS MAY BE JUST AROUND THE CORNER

A MAJOR NEW technology will soon hit the memory-chip market, providing a path to storage capacities far beyond the limits now envisioned for 2015. Call it **nanORAM**, for nanotube random-access memory. A couple of chipmakers could be cranking out prototypes next year, with mass production starting in 2005, according to the two partners that have just created the first sample using existing chipmaking equipment.

The basic concept comes from **Nantero Inc.**, a two-year-old startup in Woburn, Mass. To prove the concept, it teamed up with **ASM Lithography**, a leading supplier of equipment for "printing" chips. The main departure from ordinary procedures was laying down a thin layer of cylindrical carbon molecules known as nanotubes instead of the usual modified-silicon layer that then gets carved up into myriad transistors. Depositing the nanotubes didn't slow down the processing, says Norbert Kappel, head of ASM's Special Applications group. At the cost of the nanotubes is mere 0.1¢ per chip.

Nantero CEO Greg Schmergel says that while today's litho tools create transistors consisting of thousands of nanotubes, "we'll eventually get down to the level of addressing individual nanotubes." When transistor needs only a single nanotube, he adds, chips will "store terabits [trillions of bits] per square centimeter or roughly a million times more than today's chips. I think that may be a decade off.

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Attention Deficit: Not Just Kid Stuff

Drugmakers are starting to target an overlooked group: Adults with ADHD

MICHAEL WENDELL, A 32-year-old software engineer, always had problems in school. He had trouble making friends, couldn't stick to a schedule, and was two to three years behind his classmates in emotional maturity. By third grade, a teacher recommended that he see a therapist, who diagnosed depression. "But I didn't really fit the typical depressive profile," he says.

At 23, he went to see yet another therapist and got what he believes was the first correct diagnosis: attention deficit/hyperactivity disorder (ADHD). He now takes a cocktail of four drugs every day to keep his symptoms in check. "They really improved my ability to function," he says. "I've learned to be patient, I've learned how to listen. My whole development as a person has changed for the better."

Wendell's testimonial helps explain why Eli Lilly & Co. has been running a

major advertising campaign for the past six months to promote Strattera. It's the first drug approved by the Food & Drug Administration to treat adults with ADHD. Shire Pharmaceuticals Group PLC hopes to win the same adult designation for its ADHD drug, Adderall XR, this fall. Both companies see a huge untapped market. Over the past 15 years, mental health specialists have realized that a di-

Imbalance in the **Brain**

About 8 million U.S. adults have attention deficit/hyperactivity disorder, which is far more than an inability to multitask

DIAGNOSIS

- The patient must exhibit at least six of nine symptoms, among them persistent inattention, and poor impulse control
- The symptoms must impair daily life
- Doctors must determine that the symptoms started in childhood

OVERWHELMED

Adult sufferers change jobs more, have more money woes, and commit more crimes

agnosis long identified with children also applies to 2 to 4% of the adult U.S. population, possibly as many as 8 million people

But less than 10% of this group is getting treatment. If they started taking medication, the current \$2 billion-a-year market for ADHD treatments could easily double

"A QUANTIFIABLE DISORDER"

ONE OF THE BIG HURDLES in reaching adults with ADHD, however, is overcoming a common perception that the disorder is just a synonym for the frustration of dealing with fast-paced modern life. Hallmarks of adult ADHD can include difficulty focusing, rapid speech, impulsiveness, excessive irritability, and organizational problems—behaviors exhibited by, well, lots of people. However, Dr. David W. Goodman, an assistant professor of psychiatry at Johns Hopkins University School of Medicine, notes an important aspect of ADHD: "The symptoms may have started in childhood and persisted into adulthood," he says.

That persistence is not at all unusual. Some 3% to 5% of children have ADHD, according to the National Institutes of Health, and long-term studies have found that up to 66% of those children still suffer from the disorder as adults. These adults tend to change jobs frequently, have substance abuse and gambling problems, commit more crimes, and have a higher divorce rate than the public at large. They often suffer from depression, anxiety, and low self-esteem. "This is not just about being embarrassed," says Dr. Leonard A. Adler, director of psychiatry at New York University School of Medicine. "This is a quantifiable disorder."

Not all adults with ADHD are struggling. The high energy levels that can accompany the disorder may compensate

NEW TREATMENTS

- Strattera (Eli Lilly): A nonstimulant that corrects imbalances of the brain chemical norepinephrine, improving concentration
- Adderall XR (Shire): Waiting for FDA approval for adults, it is a stimulant that increases dopamine, improving attention



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for the downsides. David Neeleman, the 41-year-old founder of JetBlue Airways Corp., often credits his success to his own ADHD. Indeed, one survey found that about 30% of adults with ADHD become entrepreneurs. But there are plenty of disturbing data as well. Studies have shown that as few as 5% of ADHD sufferers who attend college get a degree, and it is estimated that anywhere from a third to half of the adult prison population has ADHD.

FDA OVERSIGHT

NO ONE IS SURE what causes the disorder, though it clearly has a genetic component, since it runs in families. It also occurs three times more often in boys than in girls. Brain scans of sufferers have noted a deficit of two neurochemicals in the brain's

frontal lobes, the center of learning. One, dopamine, improves attention, while the other, norepinephrine, enhances decision-making processes.

Children with ADHD have been

Lilly and Shire see a huge untapped market

treated with stimulants for decades, primarily Novartis' Ritalin, Alza's Concerta, or Shire's Adderall. These drugs raise the level of dopamine in the brain and are effective in 60% to 80% of children.

Stimulants are also effective for adults, but they're trickier to prescribe because the FDA classifies them as abusive drugs. So doctors can't call in prescriptions, and they are likely to have their records scrutinized by drug-enforcement agents if they prescribe stimulants for adults frequently.

Lilly is counting on these difficulties as it promotes Strattera, a nonstimulant that is nonaddictive. Strattera raises the amount of norepinephrine in the brain, and studies have shown that it improves a patient's ability to organize and follow schedules.

Lilly launched Strattera last January and began advertising to consumers in the spring. The ads paid off, with sales of the \$3 daily pill totaling \$75 million in the second quarter. If Shire wins FDA approval for Adderall XR for adult ADHD sufferers, there are certain to be more ads. "That might serve an important public service by raising awareness of this disorder," says Dr. Goodman. Which, in turn, could sell a lot more pills. ■

—By Catherine Arnst in New York

Is this an End Run By the NFL?

The league's new 24-hour cable channel could allow it to drive harder TV bargain

EVEN AS SPORTS HAS splintered to dozens of TV channels, an estimated 100 million folks a week still catch an NFL game on the four outlets that collectively pay nearly \$2 billion a year to televise them. That's because no one has a grind-it-out ground game like the NFL brass.

Case in point: On Nov. 4, the league will launch NFL Network, 24 hours of talk shows, highlight reels, and tidbits for pigskin junkies. With no regular-season games or even full-game classics of yesteryear, it hardly looks like a Nielsen ratings winner. So what's the strategy here? In 2005, when its \$17.9 billion in TV contracts come up for renewal, the channel could give the NFL the clout it needs to keep TV execs—worried about the high cost of sports—from trying to get a price break.

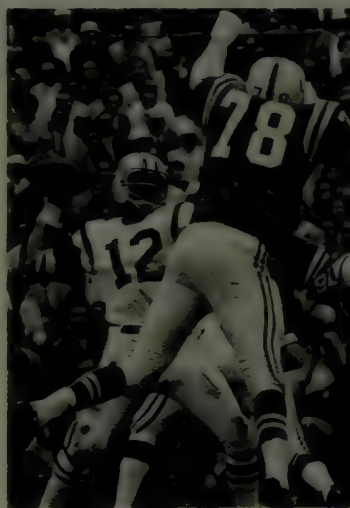
"This is about promoting the NFL, sure, but it's also about leverage," says consultant Stephen J. Solomon, a former top ABC Sports executive. For the NFL, the game plan may go something like this: Get

its channel carried on a big chunk of the nation's projected 90 million cable and satellite homes by 2005. If ESPN won't pay the NFL's price, Sunday night games would go to NFL Network. Or if CBS or Fox bargain too hard, the NFL could threaten to take away some of the

games they air on Thursday and Friday nights. "By 2005, the NFL will have learned enough to show their own games," says sports biz professor Dennis Howard of the University of Oregon.

The NFL maintains it has no live game strategy other than to run some pre-season and NFL Europe match-ups next year. "This is a channel for folks who can't get enough of the NFL now," says Steven Bornstein, the former ESPN chief who heads the league's media operations.

In any case, to create its new network—not to mention fortifying any plan to one day carry games—the NFL needs to entice cable operators. And that has been the rule. Many are still sore that the league last year extended its Sunday Ticket deal with DirecTV Inc. The satellite outfit has used that package, which costs about \$200 for up to 10 games a week, to siphon off cable customers. And the league is seeking



HIGHLIGHT
Joe Namath passing in the 1969 Super Bowl

hefty fee for NFL Network—about \$2 per subscriber, or roughly what operators pay for MTV. That's why so only DirecTV is carrying the channel.

Bornstein expects to sign cable operators before the launch—although he says he isn't likely to cut prices. One option: Cable operators who sign on now will be given a shot at bidding on NFL Sunday Ticket after 2005, when DirecTV loses exclusivity. And no doubt there are other possibilities in the NFL playbook. ■

—By Ronald Grover in Los Angeles

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Cable Fights For Its Movie Rights

Video-on-demand's reach is expanding, and the cable biz wants to show films sooner

WHEN ARNOLD Schwarzenegger's *Terminator 3: Rise of the Machines* arrives in video stores on Nov. 11, DVDs of the summer hit are sure to fly off the shelves. That will make the brass at the flick's studio, Warner Bros. Inc., very happy. Ditto for execs at retailers like Blockbuster Inc. and Hollywood Video. But there's one group in the entertainment food chain that won't be smiling: cable executives with an extreme case of video envy.

That's because cable's video-on-demand (VOD) services are far down the line and typically don't get the hot movies for six weeks after video stores get them. In the case of the California governor-elect's sequel, cable can't cash in until well after the Arnold craze is likely to have cooled off.

But a number of cable executives are looking to change all that. For one thing, video-on-demand, long promised by cable outfits, is about to take off (table). Just as important, as cable has consolidated, the industry is able to exert pressure on Hollywood to rethink the timetable for releasing movies to theaters, video stores, VOD, and outlets like HBO. At the very least, cable execs argue, they should get movies for VOD on the same day they go to retailers. Some are even calling for getting films for VOD on the day they hit theaters. "You could offer them in high-definition and charge \$40, like a pay-per-view boxing



match," Brian Roberts, CEO of No. 1 cable company Comcast Corp., suggested recently.

Hollywood has heard these arguments before, but until now it has been unwilling to jeopardize its long-standing relationships with video retailers. Suddenly, though, the moguls are listening more intently. Many of the companies that own movie studios also own cable channels. They know all too well that they need favorable deals with the nation's largest cable company. In fact, Comcast has opened up discussions in recent months with the media giants, hinting it might ne-

gotiate price and distribution deals in exchange for earlier VOD movie releases, say sources.

The problem is, even as they see a future gain from VOD, the last thing Hollywood wants to do is mess with its current bonanza in home video. Sales and rentals of VHS tapes and DVDs will hit nearly \$10 billion this year, vs. \$10 billion in box office revenues, estimates PricewaterhouseCoopers. Says Blockbuster CEO John Antioco: "At no time has it ever been more profitable and in [the studios'] best interest to protect that revenue stream than now. They would be trading a 30% margin [on a DVD sale] for a 20% margin [on a VOD purchase]."

But consumer appetites are fickle. DVD sales will level off in the coming years, say some experts. And VOD looks a lot more compelling than it did just three years ago. After having spent more than \$65 billion since 1995 to upgrade their systems, cable can now offer two-way technology that allows viewers to stop, rewind and fast-forward a movie, unlike with pay-per-view movies. Consumers pay \$3.95 for a new VOD movie, accessible for 24 hours.

But for now, VOD is at a huge disadvantage given that demand for a film is greatest in its first 35 days after it's released in video. "When people go to the TV screen and look at a movie, they usually say, 'I already went to the video store to get this one,'" says Stephen Brenner, CEO of Demand, a VOD service owned by cable operators.

Some in Hollywood are tentatively testing out the new possibilities. The major studios there own VOD services but they still honor VOD release schedules. Even so, moguls concede it may be time to experiment. Metro-Goldwyn-Mayer Chairman Alex Yemenidjian says his company has taught his industry valuable lessons. "For every dollar we make with new technology," he says, "we lose less than a dollar from all the others." Nudged by Comcast, Hollywood might just be willing to shake things up. ■

—By Tom Lowry in New York
Ronald Grover in Los Angeles,
Stephanie Anderson Forest in De

It's Showtime

Video-on-demand is set to take off

2003	2005
Digital cable homes with access to VOD (millions)*	
12.5	24.5
Revenues from VOD services (billions)*	
\$0.46	\$1.90

*Estimates. Data: Yankee Group

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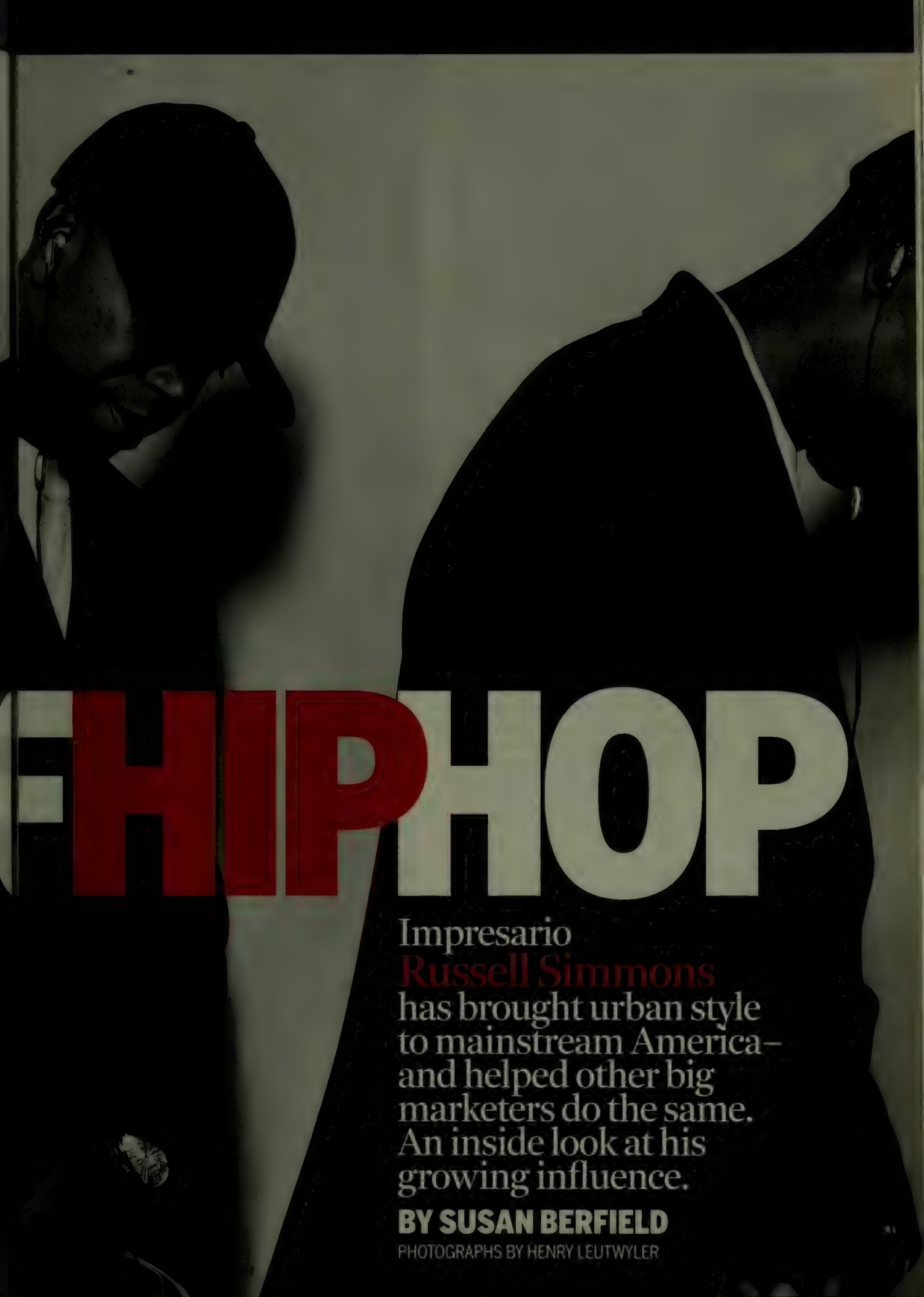
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THE CEO



HIPHOP

Impresario
Russell Simmons
has brought urban style
to mainstream America—
and helped other big
marketers do the same.
An inside look at his
growing influence.

BY SUSAN BERFIELD

PHOTOGRAPHS BY HENRY LEUTWYLER

R

USSELL SIMMONS LIVES, AND VERY comfortably at that, at a curious intersection: He's in Corporate America but not quite of it. He is, as everyone says, the impresario of hip-hop, a self-taught, self-made 46-year-old entrepreneur who in the past two decades started two of the most successful enterprises of their kind: the hip-hop music label Def Jam and the clothing line Phat Farm. Simmons, more than anyone else, has helped

bring an urban sensibility, with its bravado, its exaggerated desires, its urgent longing for the good life, to popular culture: It's the Nu American Dream.

Phat Farm, a \$263 million company, sells itself as "classic American flava with a twist" and its logo is an upside-down American flag. One of Simmons' new clothing lines, Run Athletics, is featured in Sears Roebuck & Co. and J.C. Penney Co. Another, Def Jam University, will be available in Sears next year; it alone could be worth \$100 million before the end of the decade. Already, Phat Farm does its best business in a chain of stores called d.e.m.o., located almost entirely in suburban malls. The word phat ("highly attractive or gratifying") has been added to the Merriam-Webster Collegiate Dictionary.

There is hardly a major consumer company around that isn't trying to cash in on hip-hop's singular popularity, if not its edgy authenticity. Hip-hop music, and its signature style, rap, emerged from mostly impoverished, largely African-American urban neighborhoods, grew into an entire way of life, and today dominates youth culture. It's not about race or place. It's an attitude, a state of mind. Marketing experts estimate that one-quarter of all discretionary spending in America today is influenced by hip-hop. Coke, Pepsi, Heineken, Courvoisier, McDonald's, Motorola, Gap, Cover Girl—even milk: They all use hip-hop to sell themselves. "There has been a bona fide cultural shift," says Marian Salzman, chief strategic officer at advertising agency Euro RSCG Worldwide. "This is the new mainstream," says Erin Patton, president of the Mastermind Group, marketing consultants. And, in truth, there is no easy way to fully calculate its impact on our clothes, cars, movies, music, commercials, our very language.

FLUID AND FRUGAL

SIMMONS IS WHAT YOU MIGHT call an extreme entrepreneur, and he has created a new kind of empire, one that is organic (he operates more on instinct than anything else), fluid (businesses come and go), and frugal (he usually doesn't risk much of his own money). In some ways, the company's name—Rush Communications Inc.—says it all. Rush, which was Simmons' childhood nickname, at once summons up the defiant, impatient, hungry stance that is hip-hop. "Any company that wants to tap into the youth market today has to pay attention to Russell," says Frank Cooper, the head of multicultural market development at Pepsi. "He is one of the principal architects of hip-hop culture. It's a market that is massive and that is global."

Simmons prefers to call himself a pioneer, and a generation of young, brash entrepreneurs has come to regard him as such. "Here's what other people's business plan is: Let Russell bash his head," he jokes, "and then we'll follow." Rush Communications has ventured into nearly every haunt of popular culture.



Hip-Hop Empire

From his perch atop Rush Communications, a company for his ventures, Simmons controls a diverse network of businesses:

FASHION

PHAT FASHIONS launched 1992, \$263 million sales (wholesale 2002; profits of about \$29 million)

■ **PHAT FARM MEN'S WEAR** \$127 million in sales

■ **BABY PHAT** \$38 million in sales

■ **PHAT FARM BOYS AND BABY PHAT GIRLZ** \$40 million in sales

■ **PHAT FARM FOOTWEAR** \$38 million in sales

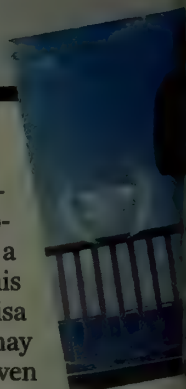
■ **ACCESSORIES** from perfume to underwear, \$20 million in sales

■ **RUN ATHLETICS** launched this year

■ **DEF JAM UNIVERSITY** out in 2004

Phat Farm has grown to include a women's line called Baby Phat as well as children's clothes, sneakers, and accessories. The entertainment group has produced two popular programs for HBO and a Tony Award-winning Broadway show. This year Simmons introduced the Rush Visa Card, a prepaid debit card for people who may or may not have a bank account. There's even a vitamin-fortified energy drink, DefCon3, that is now selling in 5,000 7-Eleven stores around the country.

Over the years, Simmons has also opened and closed an advertising agency, developed and sold a Web site, launched a



S-LATHAN MEDIA GROUP started with veteran television Stan Lathan in 1989.

MEDY JAM a stand-up comedy show that aired on HBO in years, beginning in 1992.

POETRY JAM a show featuring poetry readings, now on HBO.

RUSSELL SIMMONS DEF POETRY JAM ON BROADWAY won a 2003; an international tour begins later this year.

including *The Nutty Professor*.

LD magazine launched in 1995, 250,000 subscribers; available.

COURVOISIER
MOTOROLA on how to
urban market.

CE
SA CARD AND BABY
SH VISA CARD, prepaid
s, introduced this year to provide financial options to those
bank accounts. So far, 100,000 members have signed up.

UMER PRODUCTS

EDITION RUSSELL SIMMONS
RE i90c MOBILE PHONE,
la, introduced in 2002; Kimora Lee
phone came out this year.

an energy soda, launched in the
f 2003, sold in 7-Eleven stores.

ANTHROPY

ILANTHROPIC ARTS FOUNDATION

1995 to provide disadvantaged
access to the arts; gave away \$350,000 last year.

SUMMIT ACTION NETWORK founded 2001 with former
ad Benjamin F. Chavis. The group organizes gatherings—
part concert—in cities such as Detroit, Philadelphia, and
am. Teamed up with World Wrestling Entertainment in
er to register 2 million voters before the 2004 Presidential

Communications Inc.

thly magazine, and discarded the idea of creating a chain of
ood vegan restaurants (he long ago gave up eating “any-
g that runs away from me”). He has started the Rush Phil-
ropic Arts Foundation, which gave away about \$350,000
year to groups that introduce underprivileged kids to the
and the Hip-Hop Summit Action Network, which tries to
ade teenagers to become involved in politics.

Simmons himself has found favor with some of the most
placed companies around. He was the first person to design
ies of limited-edition Motorola Inc. cell phones with his
e on them. His wife, Kimora Lee Simmons, a 27-year-old
er model who started the Baby Phat women’s line three
ago, is the second. He also advises Motorola on how to in-

sinuate itself further into the hip-hop community, where a cell phone has become a fashion statement. As Tamara S. Franklin, the director of strategic planning and new business development for Motorola’s iDEN subscriber group, puts it: “We want to intertwine our brands.”

Simmons struck a marketing agreement with Grimoldi, an Italian luxury watchmaker, as it was first entering the U.S., largely on the basis of a single phone call he made to introduce the company’s young chief executive to Donald Trump. Simmons and Trump might seem an unlikely pair, but they’ve been friends for years. “Russell has a great ability to see where the world is going and to take advantage of it,” Trump says. These days, Simmons, who invested in Grimoldi, features the oval-shaped watches in Phat Farm ads, hands out the \$1,800-plus pieces to everyone from Arnold Schwarzenegger to Nike’s \$90 million man, LeBron James, and offers design suggestions (yellow bands for summer and, always, more diamonds).

Recently, Pepsico, the company that Simmons once threatened to boycott after it dropped Def Jam artist Ludacris as a spokesman, has taken an interest in DefCon3. “Our goal in 2004 is to become much more ingrained in the lifestyle of the hip-hop community,” says Cooper. General Motors Corp. is even considering putting out a Russell Simmons Yukon Denali. “He’s an icon,” says Chris Robinson, the director of diversity sales and marketing at GM. “What he touches usually turns to gold.”

ULTIMATE STATUS SYMBOL

FOR THESE COMPANIES, Simmons is a guide into an unfamiliar world, one that can be coarse, raw, and violent. The songs, Simmons says, are real, if uncomfortable expressions of life on the streets. In the mid-1990s, two of the most popular rappers around, Tupac Shakur and the Notorious B.I.G., were murdered. Others have lived perilously close to disaster: Beanie Sigel, a convicted felon whose clothing line is called State Property, is facing trial for gun possession. Jay-Z, who has designed a collection of Reebok sneakers, was a former crack dealer; 50 Cent, who soon will have his own line of sneakers too, boasts of being shot nine times. About which Micky Pant, Reebok’s chief marketing officer, says: “They were brought up under extraordinarily difficult circumstances. We judge people by their actions now.” There are many good reasons for this tolerance. One is that when Reebok launched the limited edition, \$100 S. Carter shoe (Jay-Z’s real name is Shawn Carter) on Easter weekend, it sold faster than any shoe in Reebok’s history. The next day, says Pant, the S dot, as it’s called, was on eBay going for \$250 a pair.

The seamy side of hip-hop is what makes Simmons so valuable to mainstream marketers who want to adopt what’s fresh about hip-hop without appearing to condone what’s dangerous. They trust Simmons to navigate the fine line between edgy and appalling, authentic and offensive. Or, as Antonio Piredda, the 35-year-old head of Grimoldi, says: “I know that Russell can figure out what is good and what is not.”

For Simmons, as much as the artists, these deals are the ultimate status symbol, a sign that hip-hop can feed off the corporate world and not just the other way around. “To us it’s not selling out,” he says. “We want what represents success.”

Simmons is in some ways the perfect 21st-century company man: a celebrated executive who unashamedly promotes his products and political concerns, often at the same time. At some 25 store appearances this year, during dozens of television and radio interviews, at the regular talks he has with school kids in

ist Eminem, grossed \$51.2 million its first weekend, more than Jurassic Park >>

his Manhattan office, at his Hip-Hop summits around the country, at his annual Hamptons fund-raiser for his foundation, and, this spring, at the rallies he sponsored to protest New York State's harsh penalties for nonviolent drug crimes, Simmons never, ever mentions one without the other. The ads for a new line of sneakers include calls for reparations for African Americans, and the label on DefCon3 says: "Energize yourself and empower your community by drinking a healthier smart energy soda that gives back." He says that a portion of sales from both the sneakers and the soda will go to the cause.

"MISUNDERESTIMATED"

YET WHEN IT COMES TO ASSESSING the relationship between his hip-hop nation and Corporate America, Simmons is decidedly ambivalent. He has seen up close how some companies try to take advantage of the urban community's ability to detect and set cultural trends without bankrolling its entrepreneurs; yet he has benefited greatly from not being taken seriously at

for his wife, who eagerly mentions that it is among the biggest homes on the East Coast. It includes an indoor pool, a movie theater, a gym, 11 bedrooms, furniture that Gianni Versace once owned, several Swarovski crystal chandeliers, at least one six-foot-tall Egyptian vase. His touches include a photograph of Lolo Ferrari hanging in the dining room and, in the foyer, an oil painting that says "Waiting Room for Colored People." In the garage are Kimora Lee's Bentley, which she's about to trade in for another long Maybach, and what Simmons calls his Osama-mobility Ford Expedition with a 500-channel TV.

On a July afternoon, Simmons sits on a yellow brocade couch in his living room, legs folded under him, his signature Motorola phone, a Motorola two-way, and a can of DefCon3 at hand. He is wearing what he always wears: Phat Farm's preppy, baggy clothes, baseball cap, and white sneakers. This is a crucial time for Simmons. After 11 years of going it alone, he's hoping to get Phat Farm, for a couple of hundred million dollars, to one of the big apparel companies so he can "amp up" and devote more of his time to designing and marketing the clothing line. Simmons

wants Phat Farm to be a multibillion-dollar business, the next Polo Ralph Lauren, and only a corporation with various resources can get him there. Simmons knows that the allure of hip-hop will inevitably fade; indeed, so far this year, sales of rap music have actually fallen 8%. Simmons' hip-hop empire is bigger than that, but still, he wants to make sure it is safely ensconced in the Establishment.

Simmons generally says what's on his mind, but Marcie Corbett, an energetic 54-year-old fashion veteran who is president of Phat Farm, has counseled that he's better off not naming names. So he continues: "There's been a lack of vision on the part of many clothing companies. We've been overlooked." Nothing infuriates Simmons more than someone dismissing Phat Farm as an ethnic label. Urban wear, it's called, is a \$2 billion business, according to Marshal Cohen, an analyst at NPD Group. It's the fastest-growing segment in an otherwise dreary fashion industry, and is sold around the country, often to white, suburban teenagers. It ranges from Phat Farm's casual chic to Sean Jean's more flamboyant men's wear (put out by hip-hop executive and J. Lo-ex P. Diddy). "If you're a retailer, you'd be blacklisted by consumers if you don't have an urban line," says Cohen. Deron Flowers, senior buyer for young men's wear at J.C. Penney, says hip-hop labels account for half of all sales in his department.

By mid-August, Simmons is more hopeful. Ruby Azrak, a boisterous, fast-talking Brooklyn native who holds a stake in Phat Farm and serves as Simmons' alter ego in the business world. He also oversees the licenses for the company and has just worked out a deal with Kellwood Co., a \$2.6 billion clothing maker, to put out the more modestly priced Def Jam University line. Hal J. Upbin, the head of Kellwood, says of his partnership

Got Something To Sell? Sign a Rapper

Big companies can't get enough of hip-hop

HEINEKEN signed Jay-Z for a commercial that debuted during the Grammy Awards telecast

GAP paired Madonna with rap artist Missy Elliott this fall

MCDONALD'S has introduced new commercials that feature a hip-hop beat and sometime-rapper Justin Timberlake

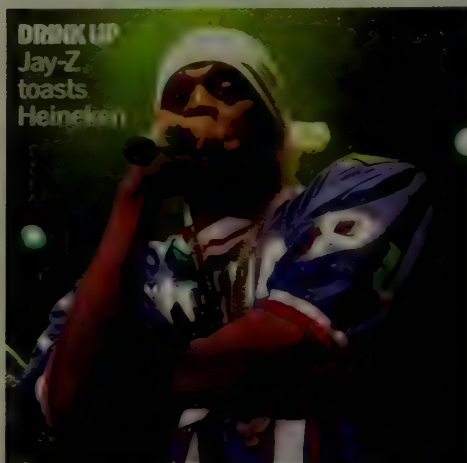
REEBOK sponsored the summer tour of hip-hop stars Jay-Z and 50 Cent

COCA-COLA backed performances by several hip-hop artists, billing the shows as Coca-Cola's Nu Classic Soul

COVER GIRL has added Queen Latifah to its roster of spokesmodels

PEPSI AND L'OREAL use singer and actress Beyoncé to promote products

THE "GOT MILK" CAMPAIGN put the milk moustache on rapper Nelly



DRINK UP
Jay-Z
toasts
Heineken



GAP GIRL
Rapper
Missy
Elliott

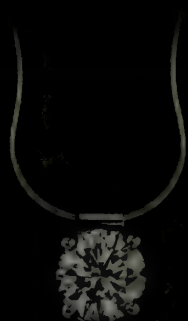
first, from being "misunderestimated," as it were. "I could complain about the lack of cultural sensitivity," he says, "but I also say that because of the old guys' stupidity I'm here in the first place. If the music business understood hip-hop in the beginning, I wouldn't have built Def Jam. If Hollywood knew about Chris Rock, I wouldn't have had *Def Comedy Jam* [an HBO show]. If the banks served these folks, I wouldn't be here with the Rush Card. I wouldn't be here without their arrogance."

"Here" in this case is an extravagantly maintained \$14 million estate in suburban New Jersey, which he bought two years ago

When the song *Pass the Courvoisier* came out last year, sales of the cognac rose 2



PALPITATIONS.



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A DIAMOND IS FOREVER



Simmons: "At first I wasn't sure what to expect. But I became increasingly comfortable with what he stands for in the hip-hop community. We would like to evolve our relationship further."

Simmons is sitting in his office, which is located in Manhattan's fashion district but looks for all the world like a men's club, with its mahogany-paneled walls, leather couch, and Oriental rug. Though he practices yoga daily and meditates in front of a shrine that includes a statue of the Hindu goddess of wealth, Laxmi, serene he is not. Simmons is hyperkinetic, uneasy with lulls, an executive whose stance is simple: Bring it on. And now that he's on the verge of making the biggest deal of his life he can't stop talking about it, even though Corbett and Azrak are signaling him to stay quiet. "You know how Wall Street wants public companies to grow?" he says. "Well, the street wants us to grow. The street is watching. The hip-hop community takes pride in growth. They love big. Not cool, small, and alternative. Hip-hop aspires to own the mainstream."

That ambition is key to understanding hip-hop's new generation of streetwise, swaggering entrepreneurs, educated, as they say, in the school of hard knocks. Indeed, almost everyone connected to hip-hop seems to have an incipient business venture or two on the side. Kevin Leong, the 25-year-old head of design at Phat Farm, has his own company, Black Bean Sauce; he created pouches for Simmons' Motorola phones. As David Mays, the 34-year-old Harvard-educated co-founder of the hip-hop magazine *The Source*, says: "People want to start their own

HOLY MAN Simmons' rapper brother Run was ordained as a minister in 1994

businesses and think they can. It's one of the staples of our culture." Damon Dash, for example, is a 32-year-old producer who, with Jay-Z, runs Roc-a-Fella Enterprises, which at count included a clothing line, music label, moviemaking enterprise, and a brand of vodka, Armadale. He states the hip-hop ethos with a certain crass elegance: "People exploit us, and we exploit them back. If they're going to make a buck off us, we make a buck off them. That's just the way it's going to be." For the lucky ones, is the Nu American Dream.

STRAIGHT OUT OF HOLLIS

RUSSELL SIMMONS STARTED OUT as a smalltime hustler in the middle-class neighborhood of Hollis, in Queens, N.Y. He was raised by parents who had both graduated from college; his father worked for the board of education, his mother for the recreation department. As a teenager, Simmons ran with the local hoodlums, sometimes dealt drugs, mostly spent the money on clothes.

He enrolled in the City College of New York in 1975, at a time when hip-hop was just emerging from the streets of Queens and Harlem. He had an immediate entrée right into the culture of it all: His younger brother, Joey, was a rapper whose group, Run-DMC, was starting to get some attention. Russell, also enterprising, became their manager, then took on other groups. He dropped out of school just short of graduation, and eventually co-founded Def Jam with another promoter, Rick Rubin, at New York University undergrad from Long Island.

Over the next decade, as hip-hop's influence spread, Russell and Joey, or Run, as he is known, lived large: They toured the world, took drugs, dated models. In those early years, though, hip-hop was still largely ignored by the major record companies. "We were left alone to incubate ourselves," says Lyor Cohen, who was born to Israeli parents, raised in Los Angeles,

started working with the Simmons brothers in the early 1980s. By 1985, hip-hop's popularity could no longer be brushed aside; Sony Corp. signed a distribution deal with Def Jam. (When the company eventually was bought by Universal Music it was combined with a rock-and-pop label to become Island Def Jam.) Throughout this time, Cohen managed the business with varying degrees of involvement by Simmons. Now the label, last year the industry's second-largest, with sales of more than \$700 million, is run solely by Cohen.

By the mid-1980s, the strangely alluring, sometimes lopsided relationship between hip-hop and the business world had taken gun. Run-DMC came out with a song about Adidas sneakers in 1986 and ended up with a million-dollar endorsement contract. "We weren't trying to sell Adidas at first. I wrote a song about what was in my life. We were doing what we loved, and money followed," says Reverend Run (he was ordained by the Ministries Community Congregation in New York in 1994). Now, in a fitting reprise, he is in charge of Phat Farm Footwear.

Since those more innocent days, marketers and rappers have set about to exploit that potential much more systematically. When Barbara Jackson, a vice-president of marketing at A.D. Domecq, the company that sells Courvoisier, wanted to introduce the cognac to the hip-hop community, she turned to Simmons' advertising agency, dRush, for help. And what do you know? In the summer of 2002, popular rappers Busta Rhymes and P. Diddy (also known as Puff Daddy) put out a song called *Pas de Courvoisier* with a chorus that included the lines: "Give me

➤ All top 10 songs on the Billboard chart in the first week of October featured rap

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ET THE FEELING

TOYOTA



MUSIC MAN Lyor Cohen runs Island Def Jam, now owned by Universal Music

money, you can give me some cars. You can give me the bitch, but make sure you pass the Courvoisier." Jackson describes her reaction: "As a marketer, you're thrilled. You can't buy this. Well, you could, but it's more credible when you don't have to." Sales of the venerable cognac spiked 20% that year. Courvoisier didn't pay Bus-

ta Rhymes for the song. It never signed a contract with him. It did sponsor grand parties after his concerts.

Simmons, of course, has been trading on his name ever since he launched Phat Farm in 1992. Back then, Tommy Hilfiger clothes had become the uniform of choice on the street, and the black-owned FUBU (For Us By Us) was starting to establish itself. Simmons figured there would be interest in an alternative if it came from him and he began putting together the pieces of a fashion company, all the while jetting back and forth to Hollywood, where he and Brian Grazer produced *The Nutty Professor*. Then he discovered yoga and met Kimora Lee, and both began to take hold of him. He gave up drinking, gave up smoking, gave up meat, gave up fur (much to Kimora Lee's dismay). And in 1998, he approached Ruby Azrak, who had been in the men's underwear business for three decades and whom he knew from New York fashion shows, for advice on how to run Phat Farm. "He was an absentee owner in the apparel business, and you can get destroyed that way," says Azrak. "He was looking for me to guide him."

Azrak's first suggestion was to get out of the manufacturing business and go into licensing instead. Two weeks later they closed a \$75 million licensing deal on a handshake. "I knew his word was fabulous," says Azrak. "That's the way he runs his life. He doesn't walk around with a posse, or bodyguards. He's not on an ego trip." Soon Azrak, a Syrian Jew who lives on the same Brooklyn street where he was born and keeps a Hebrew prayer on his office wall, took a stake in what was then about a \$15 million company. Now the apparel business is nearly 20 times that size and he, Lyor Cohen, and another investor they decline to identify own 40% of it; Russell and Kimora Lee own the rest.

Azrak describes his role this way: "I do the business deals, once the contract is signed, then everything goes to Russell. He approves all the designs, the samples, the marketing. He does try to explain hip-hop to me. I leave it all up to him."

NU AMERICAN DREAM

THESE DAYS, SIMMONS works hard at being a role model, he says: "I manage people creatively, not really as a business. I tell the kids at Phat Farm to be honest, have integrity." He asked them to read Deepak Chopra's *The Seven Spiritual Laws of Success*, and write a report. Simmons is also the cultural standard-bearer. "Everybody has to learn his philosophy," says Orr Janha, vice-president of marketing. "The Nu American Dream means to have high aspirations in life, that it's possible to be an entrepreneur. Classic American Flava means we want to be accepted by all without forgetting we're born out of hip-hop."

This, then, is the company that Russell Simmons is trying to sell to Kellwood, to Tommy Hilfiger, to the Gap, to almost anyone who can help him become what he really wants to be: an entrepreneur. "We want to sell a bunch of jeans, suits, furniture, jewelry, lingerie. Kimora is going to sell a bunch of women's clothes," he says. "We want to be distributed in Greenwich, Connecticut." This, for Simmons, is the Nu American Dream.

—With Diane Brady and Tom Lowry in New York

BusinessWeek online For more on Simmons' partnerships with Kimora Lee and Reverend Run, please go to <http://www.businessweek.com/magazine/extra.com>

URBAN PIONEER

Russell Simmons

Promoting his products and his politics at the same time

BORN Oct. 4, 1957, in a middle-class neighborhood in Queens, N.Y.

EDUCATION Dropped out of City College of New York in 1979, just before graduation.

POSITION Godfather of hip-hop. More formally, chairman and chief executive of Rush Communications, which includes, most notably, the 11-year-old clothing line Phat Farm.

STREET CRED Co-founded the hugely successful hip-hop record label, Def Jam, and sold it to Universal Music in 1999 for \$120 million. Remains chairman of Def Jam.

CORPORATE TIES Put out a signature cell phone with Motorola; offers a prepaid debit card, the Rush Visa Card; counsels Courvoisier on how to sell to the hip-hop community.



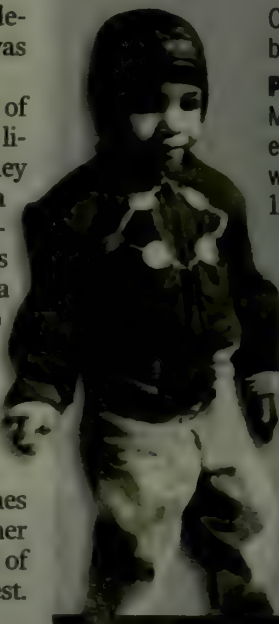
FAMILY MAN Married to 27-year-old former model, Kimora Lee; two daughters, Ming Lee, 3, and Aoki Lee, 1. His younger brother is rap star Run-DMC. His older brother, Danny, is vice-president of the Rush Philanthropic Arts Foundation.

HIS RAP "Hip-hop is all about the American Dream. They see it and they want it. We're aspiring to take over the mainstream."

WHAT'S IN HIS WALLET A Rush Card, a verse from the *Yoga Sutra* of Patanjali.

WHAT HE DRIVES (or is driven in) His "Osama-mobile," a Ford SUV with a 500-channel television.

WHERE HE LIVES A \$14 million estate in suburban New Jersey.





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Honesty Is A Pricey Policy

Execs are grumbling about the steep costs of complying with new financial controls

STARTING NEXT YEAR, manufacturers will have to prove that they can trace their products from assembly line to customer. Temp agencies will have to show that the hours they bill match those worked by their employees. And public companies in all industries will have to document that they have similar systems to keep their books in order.

The thought is giving companies the heebie-jeebies. Execs grumble that proposed new rules will be costly, cumbersome, and often redundant. What's more, the new system could put company directors into awkward relationships with their external auditors, who have been handed a fat new source of fees as well as a much-enlarged oversight role. Shareholders could also be in for some surprises: They could find that the auditors ap-

prove a company's overall numbers but give it a failing grade on internal controls.

Welcome to the brave new world of Section 404 of the 2002 Sarbanes-Oxley Act, which requires executives and auditors to evaluate companies' internal financial controls. On Oct. 7, the accounting profession's new overseer, the Public Company Accounting Oversight Board (PCAOB), proposed standards to guide auditors and companies in how to do that. The aim is to prevent the kind of financial shenanigans that caused meltdowns at WorldCom, Enron, and a host of other former highfliers.

STERN OVERSEER

SECTION 404 ISN'T the only part of Sarbanes-Oxley that irks Corporate America. Requirements to add more independent directors, especially those with financial expertise, have set off a scramble for talent at scores of companies. Executives also chafe at the law's ban on loans to cover their own relocation and housing costs as well as a confusing ban on other services auditors can provide.

But the internal control rules are by far the most contentious and potentially onerous provisions. Industry experts say that as a result of these rules, auditing costs are likely to double, while the total tab for compliance could top \$7 billion in the first year. Although most big companies can afford to pay, the costs could push some smaller companies into the red. Says Dennis R. Beresford, accounting professor at the University of Georgia: "This is going to be very, very expensive."

What's worse, the bulk of the extra expenses won't be one-shot outlays—for auditing templates—but will be incurred annually. For instance, the call for auditors to test systems every year, even if they haven't been changed.

Unless the PCAOB makes major concessions before finalizing the rule year-end, investors will receive up to separate notices each year vouching for company's numbers. Says Dixie L. Johnson, a corporate lawyer at Fried, Frank, Harris, Shriver & Jacobson: "This massive change in the way companies have to do business."

Congress figured that improved controls could have prevented WorldCom from labeling telephone-line and operating expenses as capital investments. Indeed, Beresford, who is also director of WorldCom's successor, WorldCom Group, says: "Our controls were awful. Now, we are spending millions and millions to ameliorate them."

High Hoops

Companies are up in arms about plans by the PCAOB to force them to beef up their internal financial controls. Their complaints:

- Compliance costs are likely to total \$7 billion a year for listed companies
- Auditors are charging 50% to 100% more than last year because of the extra work
- CEOs and CFOs must certify that the controls work, increasing their legal exposure
- Potential conflicts of interest arise as auditors evaluate the work of the audit committee that hired them

l, the new rules strike many executives as overkill. "This idea that a CEO doesn't know what's going on in his company is ridiculous," says George David, chairman and CEO of United Technologies Corp. "It's belt and suspenders," says P. Anderson, chief financial officer of Baxter International Inc. This year, he has to pay nearly \$10 million for audits, twice what he spent last year. And executives suspect they won't gain much benefit. Says Brian V. Turner, CFO of Instar Inc., a Bellevue (Wash.) company that operates coin-counting machines: "We know our internal controls are good, and any [extra] information I get will be marginal." Companies may also face some potential conflicts of interest. The PCAOB's draft rules will require company auditors to report how well the board's audit committee oversees the auditing of the company. In short, audit committees

and auditors will be evaluating one another.

The rules may have other farcical results. Even the PCAOB foresees that an auditor might certify a company's financial statements and at the same time say its financial controls are lacking. Auditors say this could happen when a company correctly totals its overall revenues and expenses but fails to cross-check individual transactions to stop fraud. "This undercuts a major conceit of internal controls," says Lawrence A. Cunningham, a law professor at Boston College. "It shows that controls become an end in themselves and are not nearly as effective as people think they are."

CONCEDING BENEFITS

CRITICS ADMIT THAT tighter internal controls will yield some benefits. Baxter's Anderson, for example, plans to speed up productivity investments, such as centralizing more processing of its global transactions. "I expect to emerge with a much more efficient finance organization with lower costs," he says. The new rules will give law enforcers and plaintiff lawyers a powerful tool to rebut pleas by executives and auditors that they were unaware of fraud. PCAOB Chairman William J. McDonough says the board carefully considered the costs and benefits. "We struck the right balance," he says.

His view isn't widely shared in executive suites. But there isn't much companies can do. The nonstop parade of corporate scandal makes amending Sarbanes-Oxley a political nonstarter. Besides, the safeguards might reassure investors who have tiptoed back into the market. Says Margaret M. Foran, chairman of the American Society of Corporate Secretaries: "If this is the cost of increasing investor confidence, so be it." The real test of the new rules will be whether they prevent another major scandal. And that's a big hurdle. ■

—By David Henry in New York and Amy Boston in Washington, with bureau reports

AUDIT FEES

Bean Count Bonanza

More stringent oversight of companies' financial controls isn't all bad news for business. It is certain to produce a gusher of new revenues for the usual suspects—accountants, consultants, and lawyers—who help companies with regulatory compliance. But others will get a fillip, too, particularly software makers specializing in business systems and possibly info-tech outfits that provide hardware. Across the board, companies report that they are inundated with pitches for goods and services related to the controls.

Without a doubt, the Big Four accounting firms stand to benefit most. Traditionally, they've used audits as a loss leader for other services. Now, with the avalanche of new work, they can both jack up their fees and earn more of them. As a result, they may rake in 50% to 100% more from fees next year—and hang on to them in the future. But they won't have the field to themselves. The new mandates on companies have opened the door for the smaller accountants and risk consulting outfits—such as FTI Consulting Inc. and the Protiviti subsidiary of Robert Half International—to pick up business.

Of course, much of the spending will go mainly to support the compliance effort. So the likes of Oracle, SAP, and PeopleSoft are tuning up their existing business systems to help companies document their work for auditors. Vendors such as Ariba and Concur Technologies that sell software to track and manage expenses also stand to sell more licenses.

But many smart companies are seizing the chance to improve their productivity by upgrading their IT systems at the same time. Therefore, says John Van Decker, an expert at Stamford (Conn.) researcher Meta Group, IT spending could get a \$10 billion boost in the next year—a quarter of the sector's expected growth.

—By David Henry in New York



The Bull Is Ranging Into Metals, Too

Prices are climbing, thanks to tight supplies and huge demand from China

BLAME IT ON CHINA. With newly affluent Chinese women clamoring for platinum jewelry and local manufacturers demanding copper, nickel, and other industrial metals on global markets, prices for a wide swath of commodities are soaring. Tight supplies because of past underinvestment in mines, a weak dollar, and a pickup in demand in China and elsewhere are all driving the trend. Says Paul L. Kasriel, chief economist at Northern Trust Corp.: "I believe we're in the early stages of a significant bull market in commodities."

Though the surge in the prices of metals—far outstripping modest rises in oil and gas, grains, and other commodities—hasn't yet kick-started inflation, the hikes are a big headache for some American manufacturers. Because a full-bore U.S. economic recovery hasn't yet materialized, manufacturers who try to pass along the price increases are finding that they have to absorb most of them. Says M. Brian O'Shaughnessy, chief executive officer of Revere Copper Products Inc., a Rome (N.Y.) maker of copper sheet strip and coil products: "We have to keep our customers competitive with imports."

Little relief is in sight. China has been setting the pace by importing nonferrous metals to feed its fast growing economy. It's hungry for everything from aluminum to zinc, using the materials to make goods ranging from consumer electronics to steel, as it supplies its domestic markets, the rest of Asia, and the West. Demand for steel alone is rising at a steep 20% a month. The result: Many metals are hitting highs not seen in years. Copper, now fetching about 88.45¢ a pound at the Comex in New York, is up more than 23% since Jan. 1,



High Shine

Prices of many industrial commodities are at multiyear highs

	ALUMINUM	COPPER	PLATINUM
PRICE	70.40	88.45	731.20
	CTS / LB.	CTS / LB.	DOLLARS / OZ.
HIGHEST SINCE	JAN. 2000	DEC. 2000	EARLY 1980s

Data: Comex

nearing highs hit in December, 2000. Aluminum, now trading at about 70.4¢ a pound, is approaching levels last seen early in 2000. And platinum, used in industrial products such as catalytic converters in autos as well as white-colored jewelry favored in Asia, has shot to over \$731 an ounce, the highest since the early 1980s.

China isn't the only country sucking

in commodity imports. Demand is climbing throughout Asia, particularly in Japan, where annualized growth 3.2% in the first half of this year beat U.S.'s 2.4% rise. Now, U.S. manufacturers are seeing a modest uptick in production, driving some to build up their metals inventories anew. Says James Krimmel, president of Zaclon Inc., a Cleveland company that uses zinc to make chemicals for galvanizing steel. "We've seen two consecutive months of increases in orders, and I'm hopeful that's the start of a turnaround."

Supplies of many metals have been unusually tight in recent years, as miners have underinvested in or shut down production. Throughout much of the

1990s, investors plowed their capital into Web-based businesses and other areas rather than putting it in the ground. So miners have been caught short as demand has climbed. Says Steven Strongin, director of commodity research at Goldman, Sachs & Co.: "We've had less investment and less capacity coming on line than at any time in recent memory."

BRISK RETURNS

CONSIDER NICKEL. Chinese demand for the metal used in making stainless steel, is growing at 25% a year and has doubled since 1998, making China a larger market than the U.S. But the next big mine, a major producer Inco Ltd. in Canada won't come on line until 2006, guaranteeing that supply will be pinched as the industry is already operating at near capacity.

For investors, the commodities surge may prove a profitable alternative to the stock markets. Recent gains have been brisk. In instance, the \$360 million

Oppenheimer Real Asset Fund, which invests in financial instruments tied to commodities, is up about 18% so far this year. Says the fund's portfolio manager, Ken Baum: "Commodities are offering protection at precisely the time investors most need it." So long as the global economy continues to rebound, the outlook for commodities is apt to stay bright.

—By Joseph Weber in Chicago

A photograph of a man and a woman in a medical setting. The man, on the left, is smiling and looking towards the right. The woman, on the right, is looking towards the left with a serious expression. They are standing in front of a wall with a grid pattern.

"There's not much we can do about our dependence on foreign oil. We only have so many reserves."

▲ Laron Johnson and Rima Koka/Medical Professionals

Though we do have some options. As we continue to invest in alternative energy sources like solar, the immediate need for oil and gas still remains. So we're investing \$15 billion to find and produce new energy supplies in the Gulf of Mexico. Today, nearly 70% of the oil we use to make fuels in the U.S. comes from North America.

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COMMENTARY

BY MARA DER HOVANESIAN

A Banking Rule for Another Era

Why an old prohibition against linking loans and services is obsolete

WHAT'S SO TERRIBLE? Big banks give big loans to big companies in return for a promise to do future business deals.

The banks make money by selling a bundle of services, while Corporate America gets cheap loans and a bulk discount for one-stop shopping. Yet the whole transaction may be illegal.

That's because a law born of antitrust concerns seven decades ago stayed on the books in 1999 when most other Depression-era restrictions on banks were swept away. The broader reforms allowed banks to do both commercial and investment banking. But banks of all stripes still are banned from making so-called tied loans, or loans granted only on the condition that a borrower agrees to buy other services.

It's time to dump that rule, too. As it stands, the law applies to banks that have a dominant position in the services they provide. But in today's competitive markets, "no one bank

has dominance over bank credit," says bank regulator John D. Hawke Jr., Comptroller of the Currency. The notion of widespread abuse "is one of the phoniest issues of all time," he adds. "Are we to believe that big, sophisticated borrowers are going to be coerced?" The Fed agrees. "Cross-market and cross-selling, whether suggestive or aggressive, are part of the nature of ordinary business dealings and do not in and of themselves, represent a violation," it said in an Aug. 25 statement.

Still, the debate rages on. In March, the Association for Financial Professionals, a trade group based in Bethesda, reported that 56% of companies with sales greater than \$1 billion say that a commercial bank had denied them credit or changed its terms because they did not award the bank other financial business. "It's naive to think that banks don't have market power over credit," says James A. Kaitz, AFP's chairman.

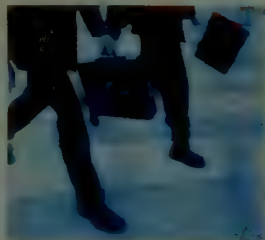
Investment bankers, no surprise, second that view. The likes of Morgan Stanley and Goldman Sachs Group Inc.—whose market share in either brokerage services or investment banking has been under attack by banks and other entrants—argue that they are at a competitive disadvantage because they have far less capital and don't want to use it for low-margin lending. Says one veteran Wall Street banker: "[Tying] is a form of extortion." But that can cut

ways: Enron Corp. executives may have bullied Wall Street into granting credit in return for receiving investment banking business.

Representative John D. Dingell (D-Mich.) has asked the General Accounting Office to investigate illegal tying—for a second time in five years. There are abuses: In August, the Fed fined German bank WestLB \$3 million for requiring that loan clients use it for debt underwriting in 2001. But after studying bank practices from 1990 to 1996, the GAO found "limited evidence" of wrongdoing. Insiders say the new report is unlikely to conclude that tying has resulted in widespread disadvantages to corporate clients.

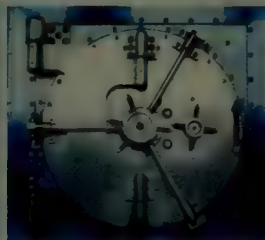
A bank is entitled to consider its overall relationship with customers before extending them credit. Some banks are doing so quite aggressively: Bank of America has more than halved its loan portfolio in three years, and Bank One Corp. dropped 200 large borrowers because they didn't do enough other business. Chief financial officers are smart enough to raise cash with bonds if they can't get bank loans. They don't need protection from an antique law harking back to the time when it was bank credit, or nothing

The Debate Over 'Tied Lending'



COMPANIES

want to borrow money from banks. But they also need investment banking services such as issuing debt or getting advice on mergers. Once that was simple, but the rise of universal banks such as Citigroup has muddled the waters.



COMMERCIAL BANKS

used to be happy to provide just credit. But that's now a low-margin business, so they also want customers to promise them some of their profitable IPO and stock- and bond-underwriting business. They insist such package deals are voluntary.



INVESTMENT BANKS

have smaller balance sheets than commercial banks, so they don't want to have to lend to companies to keep their other business. They accuse rivals of explicitly—and illegally—tying the granting of credit to other business.

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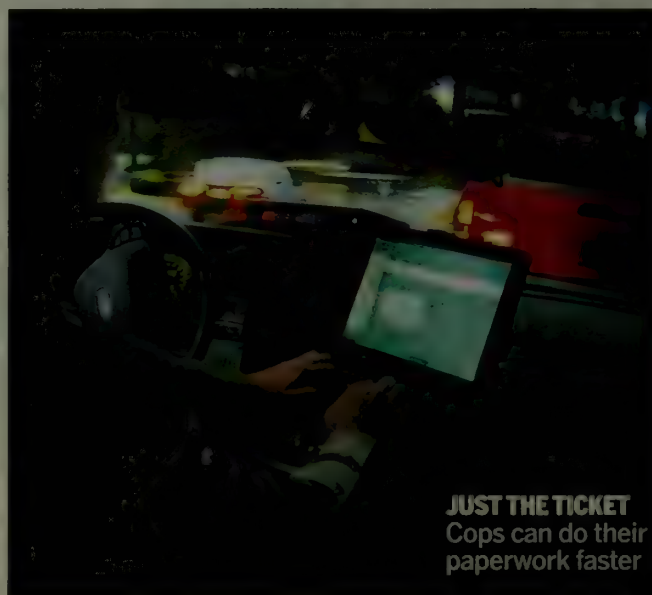
Engineering the flow of communication™

A Rehab for Microsoft's Office

The upgrade will improve productivity for employees working in groups

IF YOU'RE ZOOMING ALONG Interstate 40 outside Raleigh just a little too quickly and a cop pulls you over, you might just have Microsoft Corp. to blame. For years, North Carolina State Highway Patrol officers have been spending hours each week filling out reports. But these days, the troopers are testing a new software program that lets them fill out the paperwork on computers in their cars and then zip it electronically to their superiors at the station. The highway patrol estimates this capability in Microsoft Office will save 8,000 man-hours a year. That means more cops on the road busting speeders. "It's like having three or four extra people," says Lieutenant Brad Ward.

Office, the most widely used software application in the world, with 400 million users, is getting a much-needed facelift. For most computer users, Office is the familiar suite of word-processing, spreadsheet, and e-mail software that they use every day. It was built to improve the productivity of individual workers. But the new Office, which debuts on Oct. 21, is



JUST THE TICKET
Cops can do their paperwork faster

much more: It's a collection of products called Office System that improves productivity for groups of workers. More than just software that sits on a PC, the new Office includes software for servers, too. The lineup, which Microsoft spent more than \$2 billion developing over two

years, includes software for managing group projects, setting up Web collaboration sessions on the fly, and making instant-messaging more secure. "It's the biggest Office release since 1995," Microsoft Chairman William H. Gates says.

The new bells and whistles won't be cheap. The standard package of Office software will cost about the same as before: \$399 from a retailer. But a company that wants to take advantage of the group productivity features could end up writing a big check. The software for collaboration, called Office SharePoint Portal Server, will run \$5,619 at retail, including licenses for five employees. Office InfoPath, which lets users create electronic forms that make it easier to search

and find documents, costs \$199 per user.

The new offering should get Office sales enues going again. Office regularly topped growth in the 1990s as Microsoft packaged programs together, but in 2001, Office's growth dropped back into single digits, and revenues declined 2% two years later. Analysts think the new Office is compelling enough that it will stimulate demand and help Microsoft reach the goal of doubling Office's \$1 billion in revenues by 2010. "That's an

ambitious," but they're taking the right step, says analyst Rick Sherlund of Goldman Sachs & Co.

The new Office represents Microsoft's vision for the future of software: weaving together desktop applications with server software and services—all to make workers more productive. It's the first in an anticipated wave of Microsoft products where the distinction between applications that run on a desktop, a server, or even the Internet disappears. The worker won't be constrained by the information or capabilities of one PC. "You'll just see more and more of that in years ahead," Gates says.

GAINING GROUND

TO GET THERE, Microsoft is trying to expand its influence further into the realm of corporate computing. It faces powerful competitors such as IBM, corporate-application giants SAP, and publishing software leader Adobe Systems, all of which sell collaboration and electronic work-

Broadening Office's Appeal

Historically, Microsoft's Office suite has been aimed at improving individual worker productivity. The new Office System improves productivity for groups of workers. Here are the new pieces:

OFFICE SHAREPOINT PORTAL SERVER

Allows workers to set up internal Web sites for coordinating group projects

OFFICE LIVE COMMUNICATIONS SERVER

Instant messaging software for corporations, with security and archiving

OFFICE LIVE MEETING

Workers can launch impromptu Web collaboration conferences from the Outlook e-mail program

OFFICE INFOPATH

Replaces paper documents with electronic forms that can easily be shared, stored, and found

NY, MY WEIMARANER



As Chief Security Officer at Exostar, Jeff Nigriny has a lot on his mind. After all, clients like Rolls-Royce place their trust in Exostar's online collaboration tools. One breach, and years of work, perhaps billions in assets, might be compromised. But with VeriSign's Security Intelligence & Control™ Services, Nigriny has been freed. Freed from worrying about the day to day issues, like tracking intruders and maintaining the firewall. And freed to pursue new strategies and product applications leveraging the real-time information and response capabilities he now gets from VeriSign. He's probably working on other initiatives as well, but he didn't mention them. This guy knows how to keep a secret.

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products. Adobe, for instance, has distributed 500 million copies of its Acrobat reader, which individuals use to view documents. In spite of multiple attempts, Microsoft has not been able to unseat Adobe as the standard-setter in publishing software. "When we stay close to our core competency, we beat them," says Adobe Systems Inc. CEO Bruce R. Chizen.

That's why Microsoft is trying to capitalize on its Office monopoly to gain ground in these newer markets. The company is tightly linking new Office programs with the desktop applications most PC users already have. Microsoft has made it easy, for example, to jump from an Outlook e-mail to an instant messaging conversation using Office Live Communication Server. By piggybacking on Office's 90% market share, Microsoft taps an advantage that rivals can't match.

Standard Register Co., a Dayton forms maker, had been developing electronic forms using Adobe technology. Now it's switching to Microsoft. "It's technology that everyone has," says Doug Patterson, vice-president for digital solutions at Standard Register.

EASY TO SHARE

MICROSOFT ALSO HAS plowed new capabilities for collaboration into Office. Kevin Lloyd, chief technology officer at Barclays PLC, wanted to make it easier for the London bank's execs, who had been e-mailing huge files back and forth, to work together. He's testing SharePoint, which lets employees create Web sites quickly and easily to help them manage projects. This summer, the company set up a SharePoint site to manage quarterly budget planning for technology purchas-

es. Spending proposals were constantly reworked, but instead of sending the latest revisions around and risk losing track of changes, the execs simply posted the latest version on the group's Web site that others could review and tweak as necessary.

The new Office System is a down payment on things to come. Gates expects to release the next major version of Office the same time as the big overhaul of Windows, code-named Longhorn, which is expected in 2006. With its antitrust suit out of the way, the company is free to link its operating systems and applications. Now, we'll see if its competitors in the world of corporate computing can withstand the seemingly inexorable forces that ground its desktop software foes into dust. ■

—By Jay Greene in Redmond, Wash.

Q&A

Now, Software Won't Be Confined to the PC

In advance of Microsoft Corp.'s introduction of its next version of Office, Seattle Bureau Chief Jay Greene sat down with Chairman William H. Gates III on Oct. 10 at the company's headquarters in Redmond, Wash. Here are excerpts.

Office historically has been about personal productivity. What is the focus now?

Almost everything is group-oriented. Everything has to do with the inefficiencies that exist with people working together.

This is the first release of Office where server and service products are integrated with the PC software. Is this the future of software?

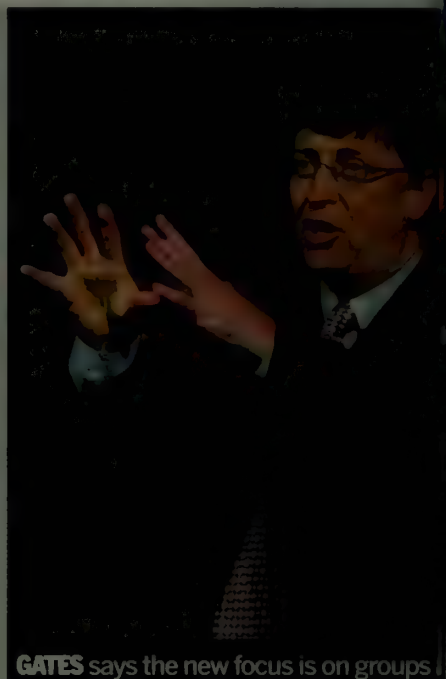
We're evolving away from the packaged product you just go buy to what we refer to as software as a service. With this new vision, you're getting regular updates of new templates. Any problems that emerge are fixed before you run into them, [and] you get things that run on the Internet that help you share schedules with other people. There is significant value that comes through the servers that Office connects up to. You'll just see more and more of that in the years ahead.

What's the most important new innovation in Office?

I'd probably pick SharePoint [which lets workers easily set up internal Web sites for group projects]. SharePoint Web sites really change how people work. In the past, to share documents, you would send attachments around via e-mail and you wouldn't know who got different versions. Now you don't have to do anything except click and start a new SharePoint Web site and then notify people that you're putting information up there.

Is this the first Microsoft product for consumers that fulfills the company's .Net vision of delivering new capabilities to people through Web services?

This is a good step in that direction. People will be able to get information through reference services, quote services, map services, shipping-charge services, and the like. They'll start to think of software as not just being contained on the PC but being able to call out to Web services to get additional things. If you don't want to compute a FedEx charge, you just call on a service for help and give it some information and it goes out on the Internet, gets the



GATES says the new focus is on groups

numbers, and brings them back into the spreadsheet.

Will the expansion into new markets boost Office's growth?

With every version we ask ourselves: Did we innovate enough that we're really going to drive that excitement? This one will meet that bar very well. It will also meet that bar at a time when corporations feel they have too many software vendors and they've let too much complexity come in, and they're scrutinizing all information-technology spending. Because of what we've done here with Office, I think the Office business will continue to be a great, profitable, high-volume business. ■



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A Wireless World

In a few years, mobile phones will dominate U.S. communications

THE DAYS WHEN THE CELL phone was a luxury for business executives and Hollywood power brokers are long gone. More than half of all U.S. consumers already have one, and many families have a slew of them. Robert Steffen, 53, a letter carrier for the U.S. Postal Service, pays for four—for himself, his wife, and his two daughters. And why not? He's forking over only about \$105 a month for all of the minutes his family needs. "Cell phones are everywhere. I would estimate that 75% or 80% of the people at the post office have one," says the 32-year postal veteran from his perch in the cab of his truck in Manhattan's Hell's Kitchen.

Rain, snow, heat, and gloom of night won't stop the inevitable: In a few years, wireless will become the dominant form of communications service in the U.S. Already, there are about 147 million cell phones in the country, compared with 187 million traditional phone lines, according to the latest figures from the Federal Communications Commission. The 20-year-old wireless business is growing at such a speedy clip that it's on track to overtake the regular phone business in about two years. "Wireless is redefining telecom," says Verizon Communications CEO Ivan G. Seidenberg.

The shift is shaking telecom's Establishment to its foundations. The big local phone companies, which had been the steadiest performers during the turmoil of the past few years, are suffering a dangerous erosion in their core businesses. For the first time ever, local phone rev-

enues began shrinking in 2001 and have slid steadily since. That has driven down profit margins for the Bells from around 39% to an expected average of 35% by yearend. Even Verizon, which has a strong wireless business, must cut costs as its core local business declines.

For companies without a solid wireless position, the challenges are more severe. Qwest Communications, for example, doesn't have a wireless business of its own, and its local phone lines, which now total 16.5 million, are dropping by about 5% per year. The squeeze may mean it won't be able to survive as an independent company. "Resolving that migration [from traditional to wireless service] is a huge issue," Qwest Chief Executive Richard C. Notebaert told investors last month. However, a spokesman says the company believes it can remain independent by bundling its telephone and Internet services with wireless service that it will buy wholesale from other telecom players.

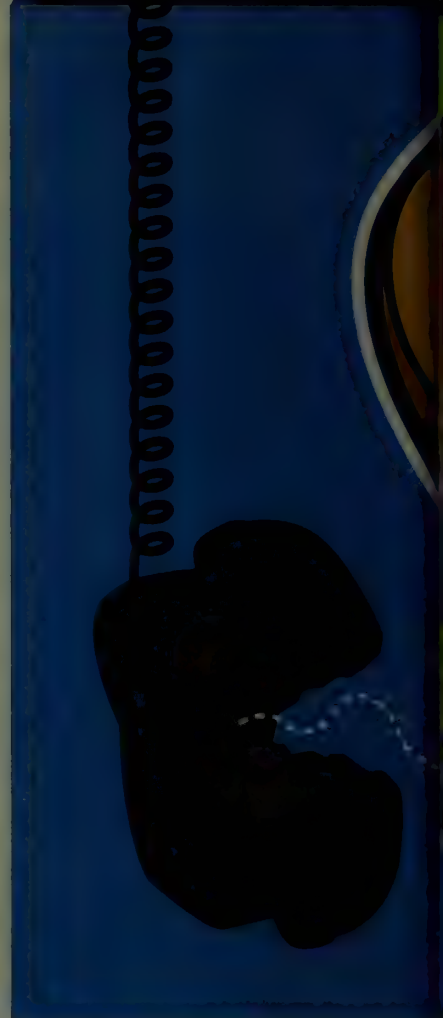
"NO GUARANTEES"

TELECOM-EQUIPMENT companies are feeling the heat, too. As phone companies such as Verizon and SBC Communications Inc. cut costs, they have less money to purchase equipment from suppliers such as Lucent Technologies and Nortel Networks. Both companies have seen severe revenue declines in recent years: At Lucent, sales dropped from \$27 billion in 1999 to an expected \$9 billion this year. That pressure will probably lead to consolidation among telecom-equipment players over the next year or two.

The implications for communications

policy are no less far-reaching. During the 20th century, federal and state regulators strictly controlled everything from prices to reliability in the U.S. telecom industry. In much of the rest of the world, phone service was a government-run monopoly like the post office or national defense. Now, the transition to wireless means governments everywhere risk losing that tight grip. "Wireless is shaking up the system. You are moving from universal service and monopoly to [a system] where service is a private contract between the company and the customer and there are no guarantees," says analyst Rudy Baca of Legg Mason. Congress held a hearing on Sept. 24 to review the public-policy challenges. Regulators in California, Utah, and Virginia are concerned enough that they're considering trying to step up their own regulation of wireless phone prices and service by the end of this year.

While the wireless future is fraught with risks for many, customers are seeing huge benefits. All the competition means choices aplenty, tumbling prices, and innovation on the rise. As cell phones come more sophisticated, consumers ending up with what is essentially a small computer in their pocket, opening up





has gone relatively smoothly. When people dial her old number, the call is automatically forwarded to her new cell phone. The couple pays about \$50 a month for a plan that provides 600 anytime minutes and 5,000 night-or-weekend minutes. The phone is generally reliable, although Tatar has some trouble picking up her voice-mail in the city and getting service at her father's house. "Overall, I'm glad I made the change," says the New Yorker, who owns a T-shirt business and attends Hunter College.

RELIABILITY GAP

AN INCREASING number of consumers are comfortable cutting the cord. About 5% of callers have ditched their regular phones, including many students and younger people. As many as 50% of consumers would like to go completely wireless, but only after differences in cost and reliability are eliminated, according to a study by Ernst & Young. Depending on features and usage, the price differential has disappeared for many people. But the reliability gap is still substantial, and some veterans of telecom think it will never close. "It's not going to displace the wire-line network," said Edward E. Whitacre Jr., chief executive of SBC Communications Inc., which jointly owns wireless player Cingular Wireless with BellSouth Corp. "It's certainly going to be a big product, but it's never going to be the substitute. Reliability is one reason."

Even if customers keep their tradi-

of new possibilities for services and entertainment. This month, State College (Pa.)-based Accuweather Inc. launched a service that beams animated radar images of weather patterns to mobile phones and other devices. FunMail Inc., in San Antonio, Calif., can zap the latest Dilbert cartoons to a cell phone. And Candida Works has pioneered a cell-phone-guided walking tour of the Lower East of New York, with narration by actor John Stiller and a soundtrack by compos-

er John Zorn. "There's no getting away from it. [The technology has] unending possibility," says Stiller, 76.

At the extreme edge of the mobile revolution are people like Lena Tatar, 34, who has completely cut the cord. Such people, although still small in number, represent the future of telecom. Late this summer, Tatar and her husband decided to shut off the regular phone at their Manhattan apartment and replace it with two wireless phones. The transition

Wireless **Tipping Point**

Mobile phone service is taking over. Half of U.S. consumers have a cell phone, and the number of mobile devices may soon exceed regular phones. Here's what the transition will mean:

TELECOM COMPANIES

Traffic shifts to wireless, traditional carriers such as Verizon and SBC will see profit margins fall from 39% in 2001 to an average of 16% this year.

EQUIPMENT MAKERS

Prices for wireless gear are falling fast because penny-pinching phone companies are putting the squeeze on gear makers. Consolidation looms.

REGULATORS

The move from regulated phones to unregulated wireless means sweeping changes. Governments everywhere will have less influence in telecom.

CONSUMERS

Lower prices, better gadgets, and a wave of innovative new services such as gambling and multimedia messaging will make consumers the clear winners in the wireless world.

BUSINESSES

Mobile Net access is transforming industries. Productivity, for example, gets a boost since salespeople are able to spend more time with customers.



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**UNPLUGGED
IN MANHATTAN**
Tatar is
all-cellular.

tional phone service, they're spending more and more of their telecom dollars on wireless. Just look at the numbers. With most of telecom stuck in reverse, revenue for the six national wireless carriers will rise an estimated 10% this year, to \$77 billion, according to Legg Mason. And wireless profit margins are rising, from 31% in 2002 to 33% in 2003.

That has phone companies racing to

diversify their revenues, adding more wireless to the mix. Wireless is likely to drive another wave of telecom consolidation over the next 18 to 24 months, according to investment bankers. It's possible that SBC, which gets just 17% of its revenue from wireless, will have to do something to catch up with Verizon, which gets 30% of its revenue from wireless. SBC has a range of options, be-

yond continuing to run Cingular joint with BellSouth. Many analysts expect Cingular will eventually wind up under the full control of either BellSouth or SBC. That would leave the other party free to acquire another carrier, such as AT&T Wireless or T-Mobile International. SBC declined comment. BellSouth says it's happy with the current structure of Cingular. In addition, Sprint, which created a separate tracking system for its wireless business, says that it is considering folding the Sprint PCS unit back in with the rest of its business in the near future.

A GREAT CONVERGENCE?

AS WIRELESS BECOMES ever more important, it is transforming the fundamental design of all other communications networks. BellSouth recently introduced a cell phone that operates as a cordless phone when the user is at home. Upstart ICG Communications Inc. is offering telephone service that is simply an application on a laptop equipped with a wireless Internet connection. With microphones attached to their laptops, workers will be able to make calls and check their voice mail from the road, just as they would read and send e-mail. "What we will see is that networks will converge. All the different devices will be processed off one network," says Frank A. Dunn, CEO of equipment maker Nortel Networks. And someday soon, all of those devices will be mobile. ■

—By Steve Rosenbush in New York
with Roger O. Crockett in Chicago
Christopher Palmeri in Los Angeles,
Peter Burrows in San Mateo, Calif.

Gadgets in The Groove

Color screens and stereo ring tones were just the beginning. In the past few months, the cell-phone market has been flooded with various new gadgets, services, and accessories. Here are some of the best:



AQUAPAC

Phone falls in your coffee? No prob if it's wearing a waterproof case from Aquapac International. Ideal for boaters, even yammering backstrokers. List price: \$25.



NOKIA 3650

Trendsetting phone has it all: calendar, contact manager, global roaming, even a camera for 15-second video clips. List price at T-Mobile is \$300, but rebates can be big.



HANDSPRING TREO 600

A phone-computer combo with calendar, contact list, full keyboard, MP3, and camera. Available with Sprint PCS—and others are coming. List price: about \$500.



LG VX6000

Verizon's first camera-phone lets users take a photo and transmit it via e-mail with just four clicks. List price is \$200, or \$150 for customers who sign a two-year service contract.

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CELLULAR SERVICE

The Mobile-Phone Plan Of the Future?

Frank Sarfeld, a public-relations consultant in Hamburg, doesn't like being tied down. An inveterate schmoozer, the 38-year-old Sarfeld spends "24 hours a day" on his mobile telephone and never goes anywhere without it. He also carries a mobile-linked handheld computer to check e-mail on the go, and he even has a vanity mobile-phone number. For someone who's self-employed like Sarfeld, the problem is how to keep up the chatter without racking up humongous phone bills. Sarfeld's solution is to use a service called Genion from cellular carrier O2. Genion's appeal: It brings mobile communications a step closer to being a true replacement for a traditional phone line.

The service lets customers choose a "home zone," which can be their house but might just as easily be a workplace, a university campus, or a favorite *biertgarten*. Inside this zone, O2 charges Genion customers as little as 3¢ a minute for local calls made via the company's cellular network. That's slightly more than a standard land line in Germany but far less than the cost of a regular mobile-phone call, which can top 60¢ a minute. "That's really saving you some money," says Sarfeld.

AHEAD OF ITS TIME

Because the home zone is about 550 yards in diameter, the low rates also apply in Sarfeld's immediate neighborhood. He can make calls on his mobile handset from the grocery store, the bus stop, or a nearby café, and, as far as his phone bill is concerned, Sarfeld is still in his living room. Outside the zone, Genion users pay mobile rates of 8¢ to 34¢, depending on time of day and where they're calling. That's competitive with other German mobile providers.

Theoretically, everyone will live this way someday. The lines between mobile and fixed-line service will blur and disappear, and everyone will be reachable everywhere for pennies. Genion is an early version of that telecommunications nirvana—and it seems to be selling. Genion has helped O2 attract about 5 million customers since launching in Germany in 1998, an 8% share

of the mobile market. The company, the last of the major operators to enter the fray, is still in fourth place in Germany. But Genion is profitable, in part because the service encourages heavy use and holds down customer turnover, company execs say. O2 doesn't report financial results for Genion separately, but three-fourths of its new subscribers sign up for the service. In the fiscal year ended in March, O2—a subsidiary of British mobile operator mm02—reported an operating profit of \$51 million. "Genion is by far our most important product," says Rudolf Gröger, CEO of O2 Germany.

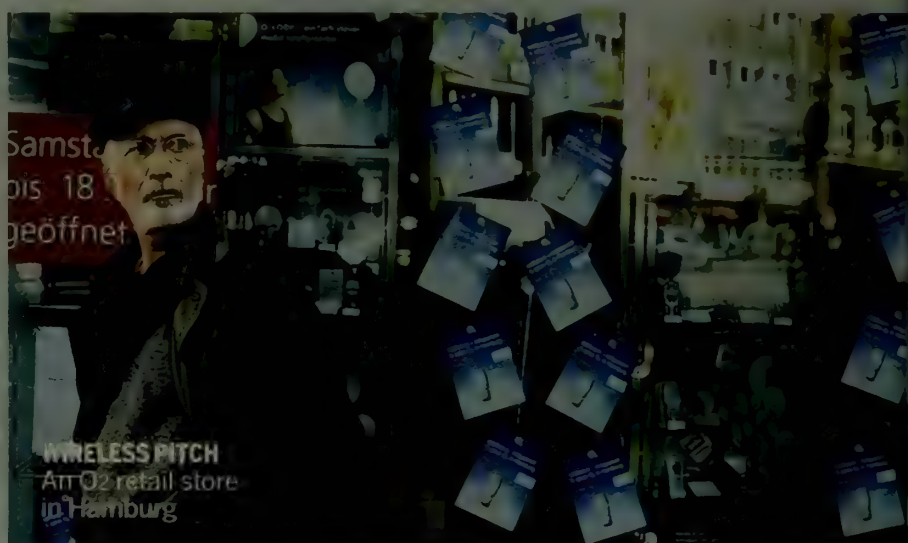
Corporate customers also are picking

bill was shameful," says Elke Brechmann, 28-year-old resident of Starnberg, south of Munich. By using the duo rate to call her boyfriend, an officer in the German army who switches his home zone to wherever he is stationed, Brechmann has cut her cell-phone bill in half.

That's not to say that all Genion users are ready to cut the cord entirely. Anyone who wants to get online, for instance, still needs a fixed phone or some form of broadband Net access. But O2's goal isn't to get customers to disconnect their existing phone lines. Instead, O2 wants to steal as many voice minutes as possible from Deutsche Telekom. "The battleground is the home," says Nicolas McQuire, an analyst at market watcher Pyramid Research.

QUASI-CORDLESS

Still, Genion is probably a transitional technology. Few other networks can determine whether a customer is in his or her home zone. "It's a unique service in the



up on Genion. Campbell Soup, Kraft Foods, and building-equipment maker Liebherr all use the service on corporate campuses and in factories. Auto maker BMW gives Genion phones to some 5,000 employees at plants in Regensburg, Berlin, and other locations. By designating the factories as home zones, workers can roam the assembly line, ever-reachable, even without paying mobile rates.

Genion isn't the only way that O2 is stealing business from Deutsche Telekom's traditional phone business. Another option, called duo, charges couples \$19.66 per month for two mobile phones. The plan lets them call each other for 8¢ a minute—just a few cents more than the cheapest long-distance rates in Germany. "My old phone

market," says John Karidis, an analyst at Commerzbank in London who estimates that other carriers won't have the technology to offer competing service for several years. Eventually, says mm02 Chief Technology Officer Dave Williams, customers will probably own a mobile phone that, at home, will function like a cordless phone that routes calls over the Internet. As even Williams concedes, such a network will remain cheaper for many years because of the relatively high cost of cellular switching equipment. "To attack wired, you have to reduce costs even further," says Williams. For now, though, Genion is the closest thing to the wireless future that the present can offer. ■

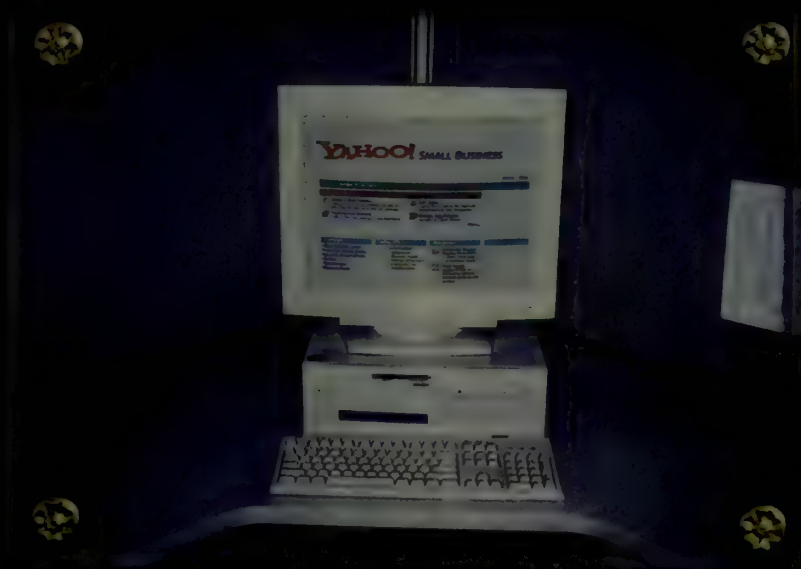
—By Jack Ewing in Frankfurt

small business

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- go to yahoo.com, click small business

EMPLOYEE OF THE MONTH



YAHOO!
Small Business

A PIONEER IN MOSCOW Brown is back after being burned once



The Oil Lord Strikes Again

With a bold deal in Russia, BP's John Brown is changing the industry

WITH ENOUGH G-force to send a drink sloshing backward, BP PLC's Gulfstream 5 roars down the runway of Moscow's Vnukovo Airport and climbs rapidly into the clear night sky. Soon a steward appears bearing Champagne and caviar. The seven executives on the plane gather around BP Chief Executive

John Brown and drink a toast to new Russian venture. "Here's to Russia," says Brown. "A country that has come so far so fast that there is no going back."

Go far, go fast: The same could be said of BP's 55-year-old boss. During his day September trip to the Russian capital, Brown packed in as much as a visit to the head of state. With police escorts parting the traffic for his motorcade, he delivered two lectures to university students and met with Russian Prime Minister M



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Kasyanov, jawed about strategy with his Russian partners, and hosted a party for VIPs among the gold-and-silver-framed medieval icons of the Kremlin Armory.

Browne had good cause to celebrate. Just days before, on Aug. 29, BP had finalized an \$8.1 billion deal with Russian oil producer TNK, one of the energy giants created in the wake of the Soviet collapse. An \$8 billion deal? In the oil patch, that's middling—Browne's acquisition of Amoco Corp. alone was \$62 billion. But that's not why this deal is special. The successful end of 18 months of secret negotiations marked the first time a Western oil company had acquired a major equity stake in an integrated Russian oil producer. BP, which vies with Royal Dutch/Shell Group for the title of the world's second-largest oil major after Exxon Mobil Corp., now has a 50% share in a new venture dubbed TNK-BP, which already pumps 1.2 million barrels a day of crude from fields in Siberia and the Urals.

But what really captivates Browne is

TNK-BP's future prospects as an exporter to its neighbors in Asia and Europe. After all, the company may have

resources on the order of 35 billion barrels of oil equivalent—nearly twice BP's current reserves. The remaining 50% belongs to a Russian group led by Mikhail Fridman, chairman of the sprawling Alfa Group conglomerate. "This is an opportunity with very long legs," says Browne.

SOVIET STYLE

BP will need years to clean up Siberia's corroded oil equipment

THE MORE THE MERRIER

NOW OTHERS ARE scrambling to keep pace. Just weeks after Browne's triumphant visit to Moscow, market sources confirmed that Exxon was in negotiations with Russia's top producer, YukosSibneft Oil Co., to acquire a stake as large as 40% for upwards of \$20 billion. Yukos is also said to be in discussions with Chevron-Texaco Corp. ConocoPhillips may be talking with Lukoil, another Russian energy

giant. The more the merrier, Browne: "If it's good for the Russian industry, it's good" for BP.

It won't be the first time Browne has seen a deal avalanche. Just five years ago, the acquisition of Chicago-based Amoco forced the other giants to go hunting. Exxon's \$87 billion purchase of Mobil followed soon after, as did Chevron's takeover of Texaco. "I think the Russian deal is analogous to the Amoco merger," says Daniel Yergin, chairman of Massachusetts-based Cambridge Energy Research Associates. "[Browne] is a game changer."

No question, Browne's timing is impeccable. Suddenly, Russia is on every investor's radar screen. The RTS index of Russian stocks is up 72% so far this year while foreign direct investment is projected to reach \$5.5 billion. Rising prices for oil and other commodities, which make up the bulk of Russia's exports, along with steady improvements in the business climate, are among the main drivers. Moody's Investors Service's decision on Oct. 8 to raise Russia's sovereign debt rating to investment grade will probably send billions in fresh capital Russia's way.

The biggest lure: Russia's 362 billion bbl. of proved oil and gas reserves, the largest of any country. With traditional sources of oil and gas in the West drying up, the hunt for new acreage is on. But there aren't that many options. Major traditional oil companies, Saudi Arabia, Kuwait, Mexico, Venezuela are still mostly the province of national oil companies. That leaves Russia, where much of the oil patch is now controlled by the private sector. At around 10 million bbl. daily, Russia's oil production is comparable to Saudi Arabia's but is growing at about 9% a year, while OPEC keeps a lid on Saudi output. And while

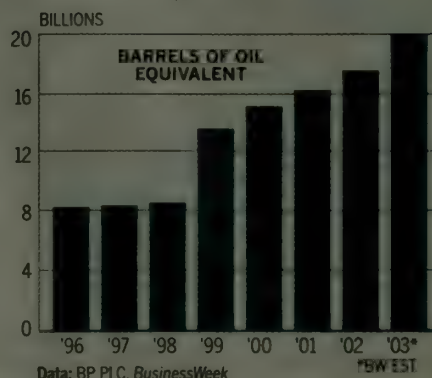
THE MAKING OF AN OIL PATCH POWER

John Browne's deal machine...

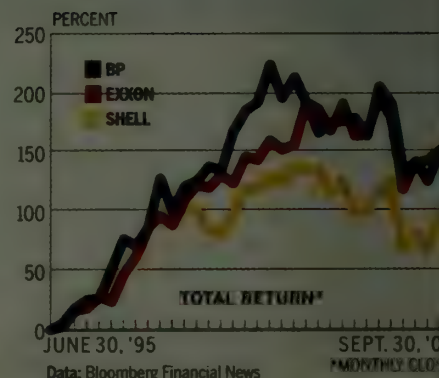
MAJOR ACQUISITIONS SINCE 1995	BILLIONS
August 1998 Chicago-based Amoco	\$61.9
April 1999 L.A.-based Atlantic Richfield	31.8
March 2000 British lubricant giant Burmah Castrol	4.7
January 2002* Germany's Veba Oil marketing and refining operations	2.7
August 2003* 50% of new Russian oil company TNK-BP	8.1

*Closing date of transaction. Others are announced dates.
Data: BP PLC, Bloomberg Financial Markets

...has pumped up reserves...



...and boosted the stock





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Saudis have kept Western oil majors at arm's length, Russian President Vladimir V. Putin stands ready to embrace them. By 2010, Russia will be "a global player and the world's largest exporter of hydrocarbons," predicts Edward L. Morse, an executive adviser at Hetco, a New York-based oil trading firm.

Despite its appeal, Russia is still a place where vendettas and intrigues incomprehensible to outsiders can make or break deals. Just look at the drama surrounding Yukos: While Putin seems ready to bless a deal between it and Exxon, government investigators are badgering Yukos boss Mikhail B. Khodorkovsky with judicial probes.

No one knows the risks better than Browne. BP was one of the first oil majors to venture into Russia following the collapse of the Soviet Union. In 1997, Browne plunked down \$480 million for a 10% stake in Sidanco, an oil company controlled by oligarch Vladimir O. Potanin but coveted by Fridman and his partners at TNK. Following Russia's 1998 market meltdown, Fridman used bankruptcy proceedings to strip Sidanco of its best assets. After a long struggle, BP cut a deal with Fridman in 2000 whereby it regained the assets and agreed to up its stake in Sidanco to 25% and explore a merger with TNK. Strange as it may seem, Browne says the battle drew BP closer to Fridman—who will serve as chairman of TNK-BP—and his partners.

SHOPPING SPREE

BP'S BOSS ADMITS Russia still has a long way to go. "The rule of law is not widespread. Corruption is widespread," he

says. Yet Browne argues that the dangers in Russia may not be as great as those in the Middle East or in West Africa and Nigeria, where BP rivals Royal/Dutch Shell and Exxon are placing huge bets. Browne is not afraid to take risks as long as the potential rewards are there: "Where everything is cut and dried there is no opportunity," he says.

The TNK deal is the culmination of a five-year shopping spree launched by Browne to turn BP from an also-ran into a top-three oil company (chart, page 120). Net income will soar 37% this year, to \$12 billion, on revenues of around \$120 billion, according to analysts.

In effect, Browne has staked BP's future on five new areas: Azerbaijan, Trinidad, Angola, Indonesia, and the deep water off the Gulf of Mexico, where BP is expanding the limits of seismic technology to find oil beneath forbidding salt domes. Now, Russia adds a sixth card to BP's hand. The newly formed TNK-BP will be the third-largest integrated oil company in Russia, with proven reserves of more than 9 billion bbl. Investment bank Dresdner Kleinwort Wasserstein in London estimates that TNK-BP will earn \$1.6 billion on \$10.8 billion in 2003.

Fridman and TNK's other major shareholders, Viktor Vekselberg and Len Blavatnik, are counting on BP's technology and management to transform TNK-BP into a company valued by international, rather than Russian, standards. BP's involvement could also smooth the way for expansion into Eastern Europe and China. "It is not so easy for a company that is just Russian, because of political suspicions," says Fridman, an affable 39-

year-old. Unlike Khodorkovsky, Fridman has managed to avoid confrontation with the Kremlin—a political plus for BP.

Browne sees a dramatically expanded role for Russia's energy wealth. TNK has huge reserves of oil and gas in eastern Siberia that it hopes to export to Japan and China. Browne says that in one move, he told Putin that Russia should become a great provider of energy to the East, just as it has to Europe.

But the British company has its cut out. TNK's oil fields are old and decrepit, with a high percentage of acreage in Siberia and the Urals. They suffer from bad salt corrosion, leaks, and environmental problems. BP's image as an environmentally sensitive company could well be tarnished by its involvement in Siberia. Browne says clearly,

Critics say Browne paid too much for his stake

everything "will take a considerable time up to 10 years. But the back conditions are an opportunity to squeeze more production by simple techniques such as drilling new

and repositioning pumps. Even with the benefit of high-end technology, TNK's output has been growing fast.

Another issue is keeping the Russians and British working together. The TNK-BP arrangement—the board and management are evenly split between Russians and BP execs—is supposed to compel both sides to work for their mutual benefit. BP is supplying 110 million barrels of oil to Russia, including CEO Robert Dudley. Russians, who have now received \$1 billion, will be paid the rest over years in BP shares and be required to keep their stakes in TNK-BP for the next five years. The BP mantra is that interests are "aligned."

Browne has so far received little credit for the deal in the financial community, which worries that BP paid a lot to gain control. "BP clearly has the leverage over the domestic Russian oil," says J.J. Traynor, Deutsche Bank in a report. But the Russians "are the financial winners."

Browne, who takes a longer view of what he heard about the new company on his trip. Production, after all, is rising more than 10% a year. Risks? Of course. But the celebrants on that speeding train in Russia, stretched out below in the darkness, is a place of infinite possibility.

—By Stanley Reed, with Jason Fichtelberg in Moscow

PUMPING UP

John Browne

He started out in one of BP's biggest gambles—the oil fields of Alaska



BORN Feb. 20, 1948, in Hamburg, Germany, son of a British Army officer and Romanian Holocaust survivor.

EDUCATION Graduated from Cambridge University in 1969, with honors in physics. MS in business from Stanford, 1984.

POSITION Group chief executive officer, BP, since 1995.

FIRST JOB Graduate trainee at BP in Alaska, 1969

EARLY SIGNS OF PROMISE In the early 1980s, sold off stakes in BP's Forties Field in the North Sea for around a \$300 million profit.

TOP ACHIEVEMENT Making BP one of the "Three Sisters."

HONORS Named Lord Browne of Madingley in 2001.

INTERESTS Collecting modern painting and pre-Columbian art.

INDULGENCE Cigars.

FAMILY Lifelong bachelor.



Patent Licensing

ology licensing, and in ar patent licensing, is an at part of a company's strategy. While licens- complex documents with important terms, perhaps gle most important f a technology licensing nt is its core n – the grant The grant identifies the ll technology vast majority crucial rights icensed. The ructure of the louse defines bject matter gy, the scope icensed, and es, field of use ns, territorial ns, and tem- itations. scope of the echnology is detailed in tions section, relevant defi- re then incor- into the grant The subject mat-

patented technology may involve the grant of rights to the Licensee to make, use, or sell the patented technology without being sued for infringement by the patent holder. The grant of rights may also be exclusive to the Licensee. It is also worth

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Lee R. Osman, Patent Group Head
www.dorsey.com

noting that unless otherwise addressed, Licensees to patented technology generally have no right to sublicense.

A grant clause may also include field of use limitations that limit the areas in which a Licensee may exploit a licensed technology to a particular field. In addition, patent licenses tend to be limited to the country or region where patent protection exists or where it is expected eventually to exist.

Lastly, technology license agreements have a temporal aspect that governs how long the rights to the licensed technology last. Where the technology involved is patented, the license usually lasts for the life of the patent.

Patent Claim Language: More Important Than Ever

Recent developments in patent law make the language used in patent claims more important than ever. Patent claims define the scope of an invention, and the outcome of most patent infringement lawsuits turns on the precise wording of the claims. Accordingly, significant attention should be paid when crafting and amending claims in the process leading up to patent issuance.

The U.S. patent laws were recently changed to encourage publication of patent applications 18 months after filing. After publication, provisional rights allow recovery of a "reasonable royalty" from infringers, but only for a claim in the issued patent "substantially identical" to a claim in the published patent application.

The Supreme Court has ruled that patent claims are to be interpreted by the trial court as a legal matter, not by a jury as a factual matter. Consequently,

"More than ever before, careful claim drafting is crucial to securing and enforcing strong patents."

most courts hold preliminary hearings to interpret claim language. Courts look at the claims themselves, the body of the patent, and the communications exchanged with the Patent Office during examination of the patent

application – all controlled or influenced by the patent applicant or its attorney. Most patent cases settle or are decided on summary judgment, without the need for a trial, once the judge has construed the claims.

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In another recent case, the Supreme Court placed significant restrictions on the "Doctrine of Equivalents," a doctrine invoked by patent owners to extend the scope of their patents beyond the literal meaning of the patent claims. The Doctrine of Equivalents is no longer available for claim language narrowed during examination, unless the patent owner can establish that an exception should apply. This is part of a recent trend restricting the Doctrine of Equivalents, forcing patent owners to rely upon the literal language of their claims.

More than ever before, careful claim drafting is crucial to securing and enforcing strong patents.

Point-of-Law

For In-Depth Downloadable Reports on These and Other Topics, Visit WWW.POINT-OF-LAW

The Elusive Employee (How To Count Those Who Count)

Debbie Wells stormed out of the office and never came back. Instead, she sued her former employer, a small medical clinic, for discrimination under the Americans With Disabilities Act.

Congress never intended that the ADA or other federal anti-discrimination legislation should impact small businesses with less than 15 employees. If the four doctors who owned and managed the clinic were not counted as employees, this clinic had less than 15 employees. Debbie argued that the doctors should be counted as employees because they were shareholders and directors of the clinic, which was organized as a professional corporation. This puzzled the doctors because they didn't function as employees at all; instead they owned and managed the clinic as proprietors. The shareholder/directors label was merely for tax purposes. The issue in this case was whether the doctors should be counted as employees for purposes of ADA coverage.

In April 2003, the U.S. Supreme Court decided this case in favor of the doctors. *Clackamas Gastroenterology Associates, P.C. v. Wells*, 123 S.Ct. 1673 (2003) holds that if the shareholder/directors (the four doctors) operate independently and manage the business, they are proprietors and not employees; however, if they are subject to the clinic's control, they are employees.

This case impacts not only small medical clinics, but also law firms, accounting firms, and architects, as well as any enterprise where the owners work in the business.

This case also impacts very large partnerships in which junior partners may not have genuine management authority. Under this case, those junior partners might actually be found to be employees.

To help businesses and the courts determine whether an

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Steven W. Seymour, partner in the firm, argued the case on behalf of Clackamas Gastroenterology Associates, P.C. before the Supreme Court. With him on the brief was Andria C. Kelly, an associate with the firm.

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individual is an employee or a proprietor, the Supreme Court adopted the EEOC Six Factor Test:

Does the individual:

1. Hire, fire or make work rules?
2. Supervise others?
3. Report to someone higher up?
4. Influence management?
5. Have an employment contract?
6. Share in the profits, losses and liabilities of the business?

The mere fact that an individual wears a particular title or label is not determinative. The Supreme Court ruled that it is not the label but the individual's participation in the business that counts.

Your Customer Goes Bankrupt How This Affects Your Business

Your slow-paying customer dependent on you for services or materials has filed bankruptcy. You welcome the bankruptcy because you believe bankruptcy gives you an "out." Your written contract says:

"A party may terminate this agreement by written notice if a proceeding is commenced under the United States Bankruptcy Code, voluntary or involuntary, by or against the other party."

Although this provision could not be clearer, you would be well advised not to rely on it. It is what bankruptcy courts call an "ipso facto" clause and is generally not enforceable. Indeed, a specific provision in the United States Bankruptcy Code invalidates ipso facto clauses.

So what happens to your contract now that it is stuck in your customer's bankruptcy? Unless you take prompt action with the help of bankruptcy counsel, you could be obligated to fulfill your side of the contract. In a Chapter 11 case, unless you formally ask

"Unless you take prompt action, your company could still be required by law to fulfill your side of the contract."

the court to require the debtor to decide early, a debtor need not decide whether to "assume" or "reject" a contract until just

before the court's hearing on its reorganization plan, often does not occur months or years after the bankruptcy filing.

When a debtor "assumes" a contract, it commits to fulfill

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its side of the bargain if it "rejects" a contract. A debtor is getting out of the contract, which could be damaging to you, even if you are no longer required to perform your side of the contract. For any damages you incur because of the rejection, you receive a "disputed claim" — usually a less than great result.

Alternatively, you may assume that your customer will fulfill the contract so that it receives what it owes you. In a bankruptcy case, this is one of the few ways in which a claim can get paid in full.

Experienced bankruptcy counsel can help you decide whether to assume or reject a contract in a bankruptcy

Dollars and Deadlines: A Tale of Nine Lawyers

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LLC sued Microsoft
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It filed the action in
ourt in Wisconsin. On
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transcend the affront and for-
give the tardiness. Indeed, to
demonstrate the evenhanded-
ness of its magnanimity, the
court will allow Hyperphase on
some future occasion in this
case to e-file a motion four min-
utes and thirty seconds late,

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*Insight provided by Jeffrey B. Wilkinson,
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with support documents to fol-
low up to seventy-two minutes
later."

The rebuke by this judge is
not the first time litigants or
their counsel were taken to task
for over-exuberance. Complex
commercial litigation is often
driven by deadlines and techni-
calities. The stakes in litigation
demand attention to detail.

However, scrutiny of corpo-
rate governance is now fierce.
In that atmosphere, above-the-
line expenses for professional
services, including legal coun-
sel, cannot escape examination.
CEO's must ask the question:
Are nine lawyers really neces-
sary to oppose a motion filed
four minutes late?

Trademarks and Copyrights on the Internet

A company's Internet domain
name can function as a trade-
mark. The United States Patent
and Trademark Office, however,
has nothing to do with the
issuance of domain names. The
differences in the way trade-
marks and Internet
addresses are issued
can result in use of reg-
istered trademarks as
domain names by oth-
ers. The Federal Trade-
mark Dilution Act has
begun to close the gap
between trademark reg-
istration and domain
name issuance policy.
It protects "famous"
trademarks from uses
by others that "cause
dilution of the distinc-
tive quality of the
mark" even where no
consumer "confusion"
– the touchstone of
traditional trademark
law – is likely.

Resolution of such
issues continues to
evolve, however, and
owners of even "famous" trade-
marks – the definition of which
remains uncertain – are not
assured of success.

Consequently, the prudent
business regularly reviews its
trademark portfolio, confirms
the registration of all its marks
(in the U.S. and abroad), regis-
ters domain names using at least
its most valuable and important
marks, and monitors registra-
tions of domain names by others
for similarities. Prompt action
should be taken to preserve
a challenge to any domain
name that might confuse one's
own customers.

Businesses also need to worry
about copyright protection and
liability in the computer age.
"Desktop publishing" in formats
that include text, photos,

drawings, video, audio, and
interactive features allowing
manipulation of another's cre-
ation implicate serious copyright
questions. Prudent owners of
important copyrights look for
infringing works on-line and



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review the registration status of
important works.

Contracts with outside com-
puter service providers must be
clear about copyright ownership
of material they exchange,
especially in regard to database
creation, a hotbed of copyright
litigation.

Guidelines for employee
Internet access are imperative
in protecting a business from
infringing another's copyright.
Internet access should be used
only for work-related matters,
and employees should be cau-
tioned about the risk of using
material they get from the
Internet. No employee should
put material on the Internet
without management review of
copyright and confidentiality
issues.

Personal Business Hotels



GOTHAM CHIC
Starwood's
W Hotel in
Times Square

NESS TRAVEL

Home Sweet Hotel

hns to rate with *BusinessWeek* readers, they need comfy rooms, high-speed access, and some little extras thrown in. **BY CHRISTOPHER PALMERI**

LIKE A GROGGY ROAD WARRIOR rubbing his eyes in the first light of day, business travel is trying to wake up from a three-year slumber. While hotel occupancies and room rates remain depressed, a recent poll of business travelers by American Express indicates that nearly 40% of them planned to travel more next year. **J** Perhaps e ramping up your travel plans, and while your airline es may be limited, hotels aren't. That's why we turned to martest business folks we know—our readers—and asked

name the best places for the busi-
aveler to stay. Nearly 1,200 sub-
s participated in this, our first hotel
They logged on to Business-
om and told us where they like to
nd why. The results were revealing.

IN
VIRTUALLY impossible to find the
best hotel. We asked readers to
their favorite property and got al-
200 different answers. But they
ater on what really counts (after
nd location, of course): 39% said
ality of the guest rooms was para-
The hotel staff and health-club
so high on the list, but the real sur-
was high-speed Internet access,
placed a strong second. "That's an

area you're going to see a lot of hotels fo-
cus on in the next year," says Bjorn Han-
son, head of PricewaterhouseCoopers'
hospitality practice.

We had no problem identifying the top
chain. Marriott International, with 24%,
was the winner by a wide margin. True,
Marriott is the largest hotelier in the
world, and its breadth of locations gives it
a leg up. But respondents almost univer-
sally lauded the company for its consis-
tency. "They never provide an unpleasant
surprise," said one reader. "In every
Marriott throughout the world, the staff is
always caring," gushed another. One
person recalled how a Marriott staffer in
Wichita made some sandwiches at no
cost after the kitchen was closed.

Such attentive service is no acci-



CURVED ROD
Westin fights
"curtain cling"

ur Business otel Survey

makes a great business hotel?
are highlights from our survey,
ran from Aug. 21 to Sept. 30 at
essWeek Online.

BESIDES RATES and location, what are
the most important amenities or
services in a business hotel?

39%	18%	17%
quality of the guest rooms	high-speed Internet access	the hotel staff

WHAT IS YOUR favorite
hotel chain?

24%	12%	8%
Marriott	Hilton	Westin & Four Seasons

dent. "We spend well over \$100 million a year on training," says J.W. Marriott Jr., chairman and CEO. "Every day there is a 15-minute exercise on things like how to greet a guest, how to handle a complaint. I tell our people: 'We don't manufacture anything. We provide experiences.'"

Consistency and number of locations were also reasons 12% of the respondents picked Hilton Hotels—the No. 2 finisher in the survey. They often singled out the company's loyalty program, which allows members to earn points for each stay in both an airline frequent-flier program and the Hilton plan. The number of brands under the Hilton umbrella was also a plus. "I can stay at a Hampton Inn and earn points toward Hilton stays," one subscriber noted. In addition to Hilton and Hampton Inns, the company's portfolio includes DoubleTree, Homewood Suites, and Embassy Suites.

No. 3 on the best-chain list was Westin, something of a surprise since, with just 120 hotels worldwide, it's much smaller than many of its rivals. Readers cited Westin's exclusive Heavenly Bed—a custom-designed mattress with 250-thread-count linens and a down comforter and pillows—and its Heavenly Shower, which features a double-headed, massaging showerhead and a curved curtain rod to prevent what the company calls "curtain cling." Parent Starwood Hotels & Resorts Worldwide is rolling out better bedding at its Sheraton properties. Close behind was Four Seasons. The 49-unit tries to make it easier on guests by letting them store luggage between visits, and providing items such as nail clippers, now verboten in carry-on bags.

FREEBIE FEST

OTHER CHAINS THAT scored well relative to their number of hotels were Hyatt, Ritz-Carlton, and W (the letter doesn't stand for anything in particular), a five-year-old brand from Starwood with only 20 locations worldwide. Readers cited its "hip" decor. Said one: "The hotel colors are bright, the design of the room creative, plus the Aveda product giveaways are a nice touch."

Indeed, many of our survey respondents



BARONIAL
Marriott's
Renaissance
Pittsburgh

indicated they like getting something for nothing, even if they are traveling on an expense account.

Readers picked Embassy Suites as the No. 7 chain overall, often mentioning the free hot breakfasts, after-work drinks, and hors d'oeuvres offered at all locations. Another reader loved Hotel Monaco's policy of putting a live goldfish in the rooms to "keep [guests] company." Hotel Monaco is a seven-unit chain, part of the Kimpton Hotel and Restaurant Group.

Hotel executives say they are responding to travelers' desire for such extras. Marriott is rolling out free in-room Internet access at all of its Courtyards, Residence Inns, TownePlace Suites, and SpringHill Suites. The higher-end Marriott and Renaissance brands are offering Internet access bundled with unlimited local and domestic long-distance calls for a flat \$9.95 per day.

Wyndham International is taking that

one step further. chain offers free guests free Internet access, long-distance calls, and personal in-room welcome bags with items like wine, beer, and perfume. These are given instead of free nights, but guests don't seem to mind. gratis telecom service made their debut last summer, members of Wyndham's loyalty program has quadrupled to 1.6 million. "People want to know they can be on a 40-minute conference call and it won't cost them 50 bucks," says Darcie Brossart, Wyndham's director of communications.

Readers' picks of favorite loyalty programs came up much like favorite chains, with Marriott first and Hilton second. Here again, readers

chose these programs for the number of locations and variety of brands under the same plan. Last summer, Marriott tweaked its program to allow frequent guests to earn free stays 30% faster than many of its rivals. "The bottom line is how soon can I take my family on a free vacation," says CEO Marriott.

Our readers have a fair amount of say in choosing where they earn frequent-traveler points. Some 85% of respondents said their company didn't require them to stay at specific hotel chains. About 60% said the hotel's location was only somewhat or not important in making their plans.

When they do look for the best rates, most travelers troll for bargains on independent Internet sites, a practice that hotel chains say they are trying to discourage. Earlier this year, for example, Hilton began requiring its franchisees to offer the same rates on Hilton.com as they do through a third-party site. Starwood says it will match any price found on an independent Internet site at any of its 740 properties. And Hyatt is offering an additional 10% off the best Internet rate you find. "The travel industry still in a state of knowledge is power." ■

WHERE DO you find the best rates?

37%

independent Internet sites

23%

in-house corporate travel department

HOW IMPORTANT is the hotel's cost in making your travel plans?

41%

very important

56%

somewhat important

3%

not important

BusinessWeek online For more results of the hotel survey, go to www.businessweek.com/magazine/extra.htm.



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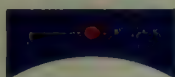
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BUSINESS OBJECTS®

BUSINESS TRAVEL

Fine Dining? Just Across the Lobby

Some of the best new restaurants are popping up in hotels. **BY AMY CORTESE**

AT TRIO IN THE Chicago suburb of Evanston, Ill., the food is eclectic, to say the least. On any particular night, chef Grant Achatz' menu might include surprises such as Chinese "bubble tea" made with cucumber, crème fraîche, and salmon roe; or Pacific sea urchin with frozen banana, puffed rice, and parsnip milk. Another surprise: The restaurant is in the Homestead, a 90-room hotel.

Today, some of the toughest tables to get are located in hotels. Unlike the stuffy, overpriced hotel restaurants of yesteryear, the new dining options can stand up to the best epicurean eateries. Hoteliers from Las Vegas to New York have lured brand-name chefs and up-and-coming talent to create "destination restaurants." Says Tim Zagat, co-founder of the Zagat Survey: "Having a hot restaurant downstairs makes the rooms upstairs more valuable." He cites Jean Georges, the gastronomic temple of Jean-Georges Vongerichten in New York's Trump International Hotel, as an example.

FRESH FROM THE FARM

WHETHER FRENCH, New American, or California Eclectic, the fare being served up at hotels these days is fresh—often bought at local farmer's markets—and

prepared in innovative ways. Just don't call it hotel food. "That says to me chicken cordon bleu, veal Oscar... what used to be called Continental cuisine," says chef Todd English, whose company, Olive Group, has opened seven hotel restaurants since 1998, including Olives at the W in New York and the Bellagio in Las Vegas. In both of these restaurants, English takes his inspiration from Mediterranean cuisine.

The changes reflect the demands of a more food-savvy clientele. "They want something unique," says Peter Koehler, general manager of the Hotel Palomar in San Francisco. They certainly get that at the Palomar's restaurant, the Fifth Floor. With its zebra-striped decor, this purveyor of "modern French" food is among the Bay Area's top-rated restaurants; its chef, Laurent Gras, graced the October cover of *Gourmet* magazine.

The boom in boutique hotels during the past decade has also fueled the trend. Hip boutiques, such as Star-

wood's W chain, have set a new standard with creative menus and artful decor. Now, big hotels are spending millions to hire celebrity chefs and make over their dining spaces. Ritz-Carlton, for example, is moving away from its tradition of generically named dining rooms (The Restaurant or The Grill) with such relative newcomers such as At  lier in New York and Maestro in Washington.

Most of these establishments have a street entrance as well as lobby access. When diners are coming in through both doors, the food must be good. ■

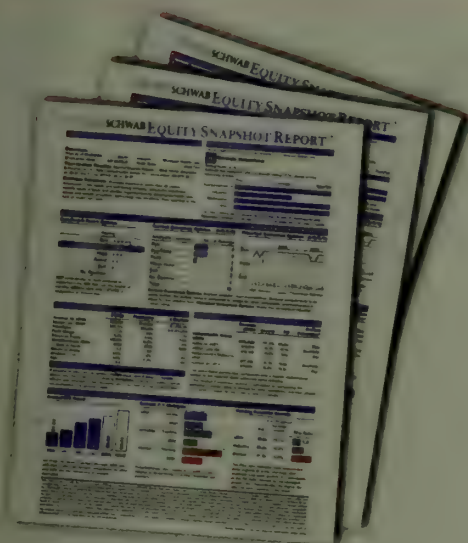


CHEF GRAS At the Palomar's Fifth Floor in San Francisco

Good Food at the

RESTAURANT	CUISINE	
CHICAGO		
SEASONS	New American	Fo...
RITZ-CARLTON DINING ROOM	New French	Rit...
TRIO	Avant-garde	Ho...
AMBRIA	New French	Bel...
RIBBONS STEAKHOUSE	American/Steakhouse	Do...
LOS ANGELES		
DEL-AIR HOTEL	California French	Bel...
BELVEDERE	Eclectic West Coast	Pe...
DIAGHILEV	Franco-Russian	Wy...
CHEZ MELANGE	Eclectic	Pa...
NEW YORK		
JEAN GEORGES	New French	Tru...
ALAIN DUCASSE	French	Ess...
ATELIER	New French	Rit...
NORMA'S	Breakfast	Le...
TOWN	New American	Cha...
SAN FRANCISCO		
MARINUS	California French	Be...
MASA'S	New French	Ho...
RITZ-CARLTON DINING ROOM	New French	Rit...
CAMPTON PLACE	Modern Mediterranean	Cam...
FIFTH FLOOR	New French	Ho...
WASHINGTON/BALTIMORE		
MAESTRO	Italian	Rit...
CITRONELLE	New French	Lat...
MELROSE	New American	Par...
SEASONS	New American	Fo...

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LEVEL BEST
British Airways leads in comfort

riers dump the business-class recliner and install seats that convert to lie-flat beds

Already, Cathay Pacific and Japan Airlines have new sleepers on some U.S. routes. Lufthansa, Northwest Airlines, and Virgin Atlantic Airways announced they, too, will be buying new planes or retrofitting old ones with flat beds in business class over the year or two.

PRICEY SLUMBER

WHEN YOU BOARD these planes, you notice a roomier cabin with fewer seats. The big differences become apparent once you're airborne. Push a few buttons, and, presto, your seat reclines, and the leg rest rises until you are lying down.

On most airlines, the beds are not horizontal, which means your feet may be under the seat in front of you. British Airways and Virgin Atlantic offer seats that adjust to 180 degrees. Typically, these lie-flat seats are no wider than a business-class chair, which generally measures 20 in. to 22 in. across. That's enough if you sleep soundly on your back but doesn't give you much room to toss and turn. In that case, you might be more comfortable on Singapore Airlines, where the armrests are 27 in. apart.

You'll pay up big time for being so comfortable. On Northwest between Detroit and Amsterdam, the first route with its new business-class cabin, a round-trip advance purchase ticket runs \$7,240 (there's no first class). A coach seat costs \$545.

Still, if an airline offers only reclining seats, while a rival advertises flat beds, you will inevitably lose business, all else being equal. So rest assured: New biz-class sleepers will keep rolling out. ■

BUSINESS TRAVEL

Flat-Out Winners

Airlines are luring business-class travelers with seats that convert to real beds **BY MICHAEL ARNDT**

AS A DIRECTOR AT Mercer Management Consulting, Mark Kadar flies to Europe every two or three weeks and to Asia at least once every few months. Business class or first class isn't the issue. He picks the airline with the best bed. "The food and the champagne and the big, cushy

seat are nice," he says. But knowing he'll need to be alert for a meeting when he lands, "the primary thing is sleep."

For now, if you're a globe-trotter like Kadar, you don't have many choices in business class. Only British Airways and Singapore Airlines offer the kind of flat beds you usually find in first class on all their routes to the U.S. But soon, you will have more options—as international car-

Sleep Well -In Coach

You don't have the budget to spend a couple of grand on a first- or business-class ticket so you can stretch out in bed on those long flights? How does \$49.95 sound?

That's what it costs for 1st Class Sleeper, an oversize pillow for those of us stuck in coach. The wedge-shaped pillow takes up

the back half of your seat cushion, letting you stretch out almost flat, albeit at a 45-degree angle. It was invented by an Alaska Airlines pilot, Bob Duncan, who for years commuted in coach from his Seattle home to his Anchorage job.

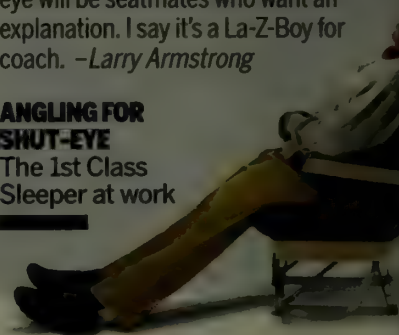
I've used it on four coast-to-coast trips now, and it's pretty comfy. It takes some getting used to, though. You inflate it only slightly—it will still be squishy—which takes only a dozen or so deep breaths. Or you can inflate it from the air nozzle over the seat.

For a Q&A with the inventor, visit www.businessweek.com/smallbiz/

During takeoffs or for short flights, I folded it in half and used it as a lumbar support, opening it fully when I wanted to nap. Before we landed, I furled it into its case, about the size of a travel umbrella.

Now, all that's keeping you from shut-eye will be seatmates who want an explanation. I say it's a La-Z-Boy for coach. —Larry Armstrong

ANGLING FOR SHUT-EYE
The 1st Class Sleeper at work



"A really
well designed
structure."

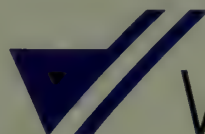
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BUSINESS TRAVEL

The Travel Agent Bosses Love

Online services have drawbacks, but that's not slowing them down. **BY TIMOTHY J. MULLANE**

next year and 50% in three years."

For now, online booking is a trade-off: You save money in exchange for doing more of your own work. Corporate travel managers say it's fine for the basic there-and-back trips that account for 80% to 90% of travel at most companies. But it's not developed enough to deliver meeting-planning, concierge-level services for executives, and international travel over the Net. Expedia, Orbitz, and Travelocity say they all offer meeting-planning services or will soon—but they offer them over the phone or in person, rather than online. Clients of the online agents can also buy special coddling for top execs—after they negotiate the fee.

BARGAINING POWER

COMPANIES MAKE THE TRADE because the savings can be substantial. Travelocity claims it can shave \$142, or about 26%, off the average business trip. That's because online service charges are lower and the big Web agencies use their bargaining power to get low fares. The biggest change is that employees who see two fares online are much more likely to

buy the cheaper one, even if it's less convenient, than are those who book over the phone. "The visual guilt is huge," says Orbitz for Business General Manager David Cerino.

Travelocity's numbers also don't include hotel savings, which can be just as significant. Why? Because online agencies, especially Expedia, control so many customers. Hotels sell them rooms wholesale, rather than marking them up, rather than selling standard-priced rooms for a commission. Some of this savings gets passed along to travelers: A CIBC World Markets study of U.S. business hotels found that travelers that use the wholesale model charge \$50 a night less than negotiated rates, and about \$100—or 40%—low rack rates.

The other reason bosses love online travel: Using Web software to manage every transaction gives managers more control over costs. Instead of receiving weekly or monthly reports on travel spending, companies now get them instantly. That helps them negotiate with specific suppliers, negotiate discounts, and identify who has been booking first class without permission. MarketStar's Jones: "I get reports

NATE COY AND Jeff Jones are of two minds over their company's switch to an online travel agency last year. Jones, the controller of Ogden, Utah-based marketing consultancy MarketStar, loves the savings he got when MarketStar moved its account to Web agency Orbitz. Coy is a sales manager who now books his trips himself and misses the in-house travel manager who used to juggle fares and schedules in emergencies. "It has worked fairly decently," says Coy, but "there's something to be said for the personal touch."

Ready or not, this is the future for business travelers. The Big Three of the Web—Expedia, Travelocity.com, and Orbitz—have all launched services aimed at businesses during the past year, slashing standard processing fees of \$30 per booking to as little as \$5. Pressure from insurgents—and customers—is pushing giant corporate-travel agencies online, too. The largest, American Express, says e-bookings now account for 25% of its transactions. Says Danny Hood, president of Atlanta-based WorldTravel BTI, the nation's No. 5 business-travel agent: "We're at 20%. We think it'll be 30%

Booking on the Net

AGENCY	FEES	SPECIAL FEATURES
Expedia	\$5 per online booking 20 by phone	Much larger selection of discounted hotels for small companies. Integrates expense reporting and other corporate functions.
Orbitz	5 online 20 by phone	"Flex search" will check dates around your planned trip to suggest money-saving alternatives. Claims largest selection of low fares but doesn't always show lowest fare.
Travelocity	5 online 20 by phone	Based on a proven booking engine already used by AmEx and others.
American Express	0 to 5 online 15 by phone	More online access to on-ground services, such as limos and meeting planning, than rivals, plus more staff to solve problems.

STAY BUSY



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what's going on and who are the biggest offenders, so I can follow up."

Over time, online business travel will save time too. Marc Benioff, CEO of San Francisco-based Salesforce.com Inc. and an Expedia client, says software companies will soon integrate with Expedia. His example: A sales professional who books an out-of-town appointment might type

the visit into a calendar. The software would then forward the information to the online agency, which would automatically book the trip and add the bill to an expense report. "To maximize profits, you have to manage travel," says Salesforce e-business manager Bill Kammerer.

For now, companies are juggling how much self-service to impose on workers.

As the online travel sites search for the right formula, the winners are business travelers who make the same trip often and can store flight and hotel preferences online. The dogged business traveler going six cities a week will pine for the days when Alice in the travel department took care of everything. But increasingly, Alice doesn't work here anymore. ■

Day Trip



BUSINESS TRAVEL

Popping Up To the DMZ

It's just a bus tour from Seoul. **BY CHESTER DAWSON**

NO BLUE JEANS, SHORTS, sandals, or booze. That might not sound like the makings of a fun trip, but it doesn't discourage the more than 150,000 tourists a year who flock to see one of the last vestiges of the Cold War: the DMZ. That's soldier shorthand for the Demilitarized Zone, which separates South Korea from its hard-line communist neighbor, North Korea. Bus

tours to Panmunjom, the "truce village" under U.N. supervision that straddles the tense border, are a fascinating day trip for business travelers to Seoul with some free time on their hands. The tours run about \$60, with lunch.

Just 37 miles north of the South Korean capital, the area around Panmunjom is anything but demilitarized. Civilian bridges feature prominent slots for dynamite so they can be blown up at the first sign of invasion. Sandbagged foxholes

and barbed wire fences line the thoroughfare, marring the view of basic farmland and the coast beyond. Closer to the border, commercial traffic is perceptibly slowed, and roadblocks are manned by heavily armed South Korean and U.S. military police. The end of the road is Camp Bonifas, a U.S. military post that is run under the auspices of the U.N. Command Security Force. It serves as a trip wire for any surprise invasion by the North's 1.1 million-strong army. The camp's motto: "In Front of Them All."

An uneasy truce has held since 1953, when an armistice divided the peninsula at the 38th parallel. Visitors are bound by strict protocol (no unauthorized snapshots or finger-pointing at North Korean guards) and then escorted to the visitor center at Panmunjom just 440 yards away.

PALATIAL HALLS

THE DMZ ITSELF is a no-man's-land that runs for 151 miles across the peninsula. It is only 2.5 miles wide. The strip is so isolated that it has become a wildlife refuge for endangered birds and bears. The square-yard U.N. Joint Security Area at Panmunjom, however, seems more like Disneyland than DMZ. Watchtowers are interspersed among palatial halls that showcase each side's grandeur and contain visiting dignitaries. Barbed wire and mine fields are replaced by little more than a line in the sand—which a handful of defectors (from both sides) have crossed in the past 50 years.

Enter one of the blue barrack buildings that straddle the border. You walk past the long green felt-covered negotiating table to the opposite side of the room. Outside the window you can see a change in the texture of the pavement. Welcome to North Korea. But don't forget a passport stamp: Beefy South Korean guards block access to the door to the North. Bus tours may soon be a part of history. In June, the U.S. announced plans to move troops 75 miles south of the border.

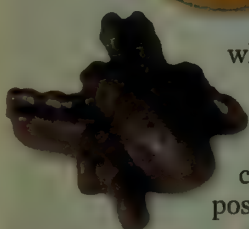
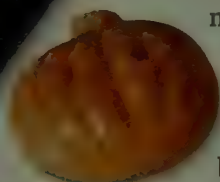
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Upgrade from a power nap
to a good night's sleep.

EDITED BY TODDI GUTNER

CHOCOLATE CREEPY CRAWLY CANDY

LOOKING FOR grownup sweets this Halloween? Inspired by horror flicks, candymaker **Ethel M. Chocolates** is offering collections of spooky chocolates at ethelm.com or 800 438-4356. The 22-oz. *I Walked With a Zombie* box for \$32 stars such confections as brown spiders, orange pumpkins, and green letters that spell "Boo." If novelty candy scares you, try the more traditional one-pound *The Body Snatcher* box of assorted chocolates for \$28, which includes Ethel M's signature Almond Butter Crisps and Satin Cremes. Both box covers feature classic RKO Pictures movie posters. Ethel M. Chocolates, based near the Las Vegas strip in Henderson, Nev., is the premium candy division of Mars Inc.



FUNDS

The Past as Forecas

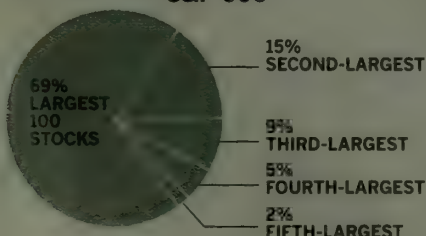
PAST PERFORMANCE IS no guarantee of future results. That's the disclaimer slapped on every mutual-fund advertisement and prospectus. Yet implicit in every ad is a suggestion that, yes, these great performances will continue. And investors flock to top-performing funds. Still, the question lingers: Can past performance predict future returns? Analysts at mutual-fund tracker **Morningstar** examined the results of nine different U.S. diversified equity fund categories from 1992 through 2001, looking at one-, three-, and five-year returns. Each fund was stacked up against its peers in its category to gauge relative performance.

By and large, the disclaimer turned out to be true. Still, there were notable exceptions. Past performance is more predictive for funds that invest in large-company stocks. That's because these funds tend to have larger asset bases and lower expenses, says Morningstar analyst Jeff Ptak. Value-oriented funds are also more likely to stay on top. They buy and hold securities for long periods of time, reducing overall volatility and providing more consistent returns. —Lauren Young

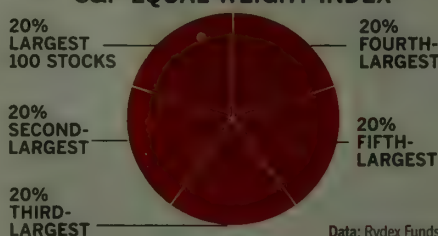
STOCKS

THE STANDARD & POOR'S 500-stock index is up 18.8% this year through Oct. 13, but an index of the same 500 stocks held in equal amounts has gained 28.1%. Why? The S&P is heavily weighted toward large-cap stocks, and they're trailing the smaller stocks. The six-month-old **Rydex S&P Equal Weight Exchange Traded Fund** (RSP) is the only way to get an equal-weighted S&P, short of buying an equal number of shares in 500 companies.

S&P 500



S&P EQUAL WEIGHT INDEX



TIME OFF

WHERE THE LEAVES ARE

LEAF PEEPERS REJOICE: The late-summer wetness won't dull the palette as America's trees reach their peak autumn colors in the next few weeks, according to researchers at Pennsylvania State University. Go to the U.S. Agriculture Dept.'s Forest Service Web site (www.fs.fed.us), or call the toll-free hotline (800 354-4595) to check on the progress of fall color in your region. The Foliage Network's updated maps also help you monitor peak conditions nationwide (foliagenetwork.com).

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BY ROBERT BARKER

Too Late to Jump Back Into Tyco?

Numbers course through stock markets like blood through the living. Common as numbers are, we can thank Tyco International's ex-execs, the most exalted of whom now stand trial a brisk walk north of Wall Street, for two fresh sets sure to get investors' pulses racing: "lawyer hours" and "accountant hours."

In Tyco's case, these would be 15,000 of the lawyer variety and 50,000 of the accountant's. Tyco consumed them after its former CEO, Dennis Kozlowski, and CFO, Mark Swartz, left last year amid charges they had looted the company, allegations to which they have pleaded innocent. Tyco's new CEO, Motorola veteran Edward Breen, had to end his first year in July by restating Tyco's financials back to 1998. And, as the Kozlowski-Swartz trial began in September, Tyco took out big advertisements reminding us of its new order. "Despite the distractions of the recent past, Tyco is a \$37 billion company that sells real products to real customers," they say. "The present is great. But our potential for growth in the future is even greater."

Is it? At \$22 a share, Tyco has nearly doubled from its low in March. While Breen is keeping quiet until Nov. 4, when Tyco reports its results for fiscal 2003, ended Sept. 30, he already has signaled 2003's likely outcome and raised expectations for improvement in the years ahead. Given Tyco's new financial basis and outlook, the question for investors is whether the stock remains a growth opportunity.

TYCO'S \$37 BILLION in fiscal 2003 sales came from dozens of units grouped into five segments (table): Fire & Security, with its ADT Security Services; Electronics, which makes connectors, cables, and many other components, high-tech and low; Healthcare, where it notably competes with Johnson & Johnson in

surgical supplies; Engineered Products & Services, a maker of such heavy-duty stuff as valves; and Plastics & Adhesives, a major seller of duct tape, clothes hangers, and trash bags.

If many of these businesses lack glamour, the good news is that Tyco expects they yielded \$2.2 billion to \$2.5 billion in free cash flow during the fiscal year just ended. The bad news is that most or all of the company's 4% gain in revenue in its first nine months owed to changes in foreign currencies. And from the standpoint of a prospective investor, the worse news is that despite shadows cast by the trial, the stock market already fully expects Tyco to make good on its potential.

Tyco's market value comes to \$48.5 billion. Tyco also has \$17.8 billion in cash. Add the two to find how much capital a theoretical buyer of the whole company would need to acquire it, and Tyco now has a total enterprise value of \$66.3 billion. Breen has told the Street he sees revenue growing 5% or more over the next few years, but that cash flow can expand much more rapidly. Suppose it surges by 25% or so to, say, \$3.5 billion in the current year. On its present enterprise value

that would be a 4.5% cash return. How does this compare with so many other citizens among Tyco's peers? Not well. J&J's free cash flow could be flat and still return nearly that much, 4.3%. Ditto 3M's. What if there's a hike in Tyco's 5¢ annual dividend to a yield of just 0.2%? For now, Tyco plans to divert spare cash to cut debt and bolstering its pension plans. Stock in J&J and 3M come with dividend yields of 1.9% and 1.8%, respectively.

With the stock reflecting a fair valuation, Tyco's new leaders could be proud of stabilizing the company and starting to work off its financial debts. As for the moral obligations racked up by their predecessor, they will have to keep an eye on Manhattan's criminal court. If Kozlowski and Swartz are convicted, they could face prison terms of up to 30 years. For each, that would add up to 262,980 "convict hours," a memorable contribution to Wall Street numerology. ■

E-mail: rb@businessweek.com



Piecing Tyco Back Together Again

SEGMENT	REVENUES	OPERATING INCOME
Fire & Security	\$11,263	\$451
Electronics	10,265	-871
Healthcare	8,473	2,032
Engineered Products & Services	4,794	340
Plastics & Adhesives	1,901	136

All figures are in millions for the 12 months ended June 30.
Data: Company reports; BusinessWeek

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BY GENE G. MARCIAL

MOVIE STUDIOS MAY BE HOT AFTER **IMAX**' BIG-SCREEN SYSTEM

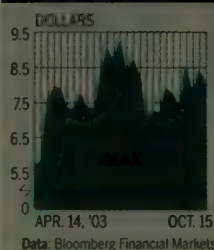
TRAFFIC IS BRISK AT T.J. MAXX, SO OWNER **TJX** LOOKS LIKE A BUY

PRIME HOSPITALITY IS A CHEAP PLACE FOR INVESTORS TO LODGE

Imax: The Chase Is On?

RUMORS SWIRLED LAST YEAR that Imax (IMAX) was being pursued by Sony. Now, Sony may not be the only suitor. The pioneer in sound and projection for giant-screen theaters is a huge success, and movie studios are eager for its technology. (Imax screens can be eight stories high and 120 feet wide.) Some investors believe it will deliver blockbuster gains. They argue the company would be a "strategic catch" for Viacom or Time Warner, both of which are also possible bidders. Shares have soared from 3 in February to nearly 10 in July, before easing to 8.09 on Oct. 15. Bret Rosenthal, investment director at Wachovia Securities, which owns stock, is convinced it will double in a year. He says demand is rising for Imax' new technology, which lets studios convert 35mm films into the 15/70mm Imax format. Imax also has a new system to build stand-alone Imax theaters for 50% less than now. All this will swell demand for Imax format films, says Rosenthal. An Imax version of *The Matrix Reloaded* was released in June. *The Matrix Revolutions* is due on Nov. 5, and sequels to *Spider-Man* and *Harry Potter* are planned. Eric Wold of investment boutique Merriman Curhan Ford rates the stock a buy and figures Imax will earn 13¢ a share in 2003, on sales of \$133 million, and 35¢ in 2004, on \$159 million. Co-CEO Richard Gelfond says he's in talks with major studios to "Imax-ize" their big-event films. As for buyout rumors, Gelfond says when Imax attains its goal of widening its stock of films, "that will be the time to assess the stock price—and our alternatives." Time won't comment, although pros note that it is on a debt-reduction path. Viacom was unavailable for comment.

FRESH BUYOUT WHISPERS

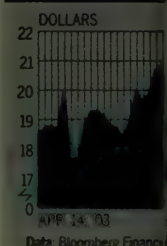


Merchandise Floods Into TJX Stores

IF RICHARD STEINBERG of Steinberg Global Asset Management wants to know how well companies are doing, one thing he does is talk to their shippers. So when an insider at a big trucking outfit told him that its business with TJX (TJX) had jumped to its highest level in 10 years, he quickly loaded up on TJX shares. Ballooning shipments, he says, mean business has blossomed for TJX, the world's largest off-price retailer of soft goods, and inventory levels are improving. In the

U.S., it operates 742 T.J. Maxx stores, 658 Marshalls, 168 HomeGoods, and 89 A.J. Wrights. In Canada, it has 158 Winners and 23 HomeSense stores, and in Europe, 137 T.J. Maxx outlets. Yet the Street isn't hot on TJX, because it fears consumer spending may cool. But Steinberg thinks the stock, which has risen from 15 in February to 21.23, is trading at attractive levels relative to its peers, based on the ratio of its p-e to its growth rate. He figures it is worth 29, or 20 times his earnings forecast of \$1.45 a share for 2005 (ending Jan. 31). The current price-earnings ratio is 14. His estimate for fiscal 2004 is \$1.22. "TJX is a bargain," he says.

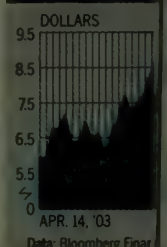
SOFT GOODS HARD RESULT



Checking In At Prime Hospitality

NO MAJOR STREET ANALYST is high on Prime Hospitality (PDQ), which owns and franchises 22 hotels in the U.S. and the Virgin Islands, mainly AmeriSuites and Wellesley Inns & Suites. But Ben Segal, president of Winchester Capital Management, likes Prime for three reasons: The stock sells below its book value of 15.21 a share. It's poised to snap back with the economy. And it's takeover bait. The stock leaped from 4.58 in March to 8.74 on Oct. 15—still way below book. Analysts are down on Prime, he says, because they go for earnings growth. "But," says Segal, who owns shares, "Prime is mainly an asset play"—with low debt and ample cash to cover it. CEO Attilio Petrocelli, who has 3.5 million shares, continues to buy shares in the open market. Segal notes that few CEOs buy shares in the open market with their money, instead of through options. Spokesman Richard Hulnick wouldn't comment on the buyout speculation. ■

HEADING FOR THE ROADS



BusinessWeek online

Gene Marcial's Inside Wall Street is posted businessweek.com/today.htm at 5 p.m. on the magazine's public site usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNN Money Gang.

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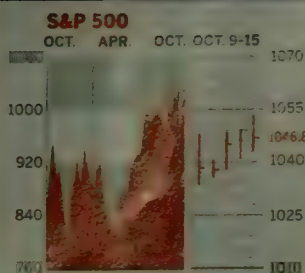
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Figures of the Week

STOCKS



COMMENTARY

A great earnings report from Intel, along with a spate of good reports from such bellwether companies as General Motors and Merrill Lynch, sent equities higher. And there was good news on the economic front as manufacturing showed signs of reviving and jobless claims fell. Goldman Sachs raised estimates for 2003 third-quarter GDP growth.

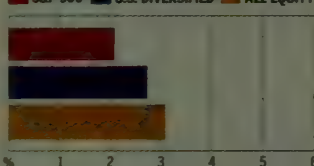
Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN

WEEK ENDING OCT. 14

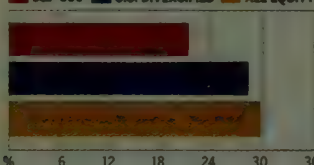
■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



52-WEEK TOTAL RETURN

WEEK ENDING OCT. 14

■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



Data: Standard & Poor's

U.S. MARKETS

	OCT. 15	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
S&P 500	1045.1	1.3	19.0	15.5
Dow Jones Industrials	9803.1	1.8	17.5	18.7
NASDAQ Composite	1939.1	2.4	45.2	51.2
S&P MidCap 400	540.7	1.2	25.8	28.0
S&P SmallCap 600	254.1	2.1	29.2	34.7
Wilshire 5000	10,174.8	1.4	22.0	22.7

SECTORS

	OCT. 15	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
BusinessWeek 50*	500.1	1.1	10.6	6.1
BW Info Tech 100**	338.5	1.2	18.6	24.4
S&P/BARRA Growth	529.6	0.8	18.0	14.5
S&P/BARRA Value	513.5	1.7	20.0	23.2
S&P Energy	202.4	0.0	10.5	7.6
S&P Financials	364.3	2.1	22.7	21.8
S&P REIT	111.8	0.3	23.1	27.9
S&P Transportation	188.2	2.9	10.8	9.9
S&P Utilities	111.5	-0.4	14.0	32.7
GSTI Internet	147.9	2.7	95.1	105.1
PSE Technology	565.1	2.1	45.1	55.4

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	OCT. 15	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1035.9	2.4	22.7
London (FT-SE 100)	4368.8	2.3	10.9
Paris (CAC 40)	3375.0	3.9	10.2
Frankfurt (DAX)	3570.6	5.2	23.4
Tokyo (NIKKEI 225)	10,900.0	3.4	27.1
Hong Kong (Hang Seng)	12,056.2	2.9	29.3
Toronto (S&P/TSX Composite)	7783.2	2.8	17.7
Mexico City (IPC)	7843.7	0.4	28.0

FUNDAMENTALS

	OCT. 14	WEEK AGO
S&P 500 Dividend Yield	1.59%	1.60%
S&P 500 P/E Ratio (Trailing 12 mos.)	29.2	28.9
S&P 500 P/E Ratio (Next 12 mos.)*	17.7	17.6
First Call Earnings Surprise*	8.06%	13.77%

TECHNICAL INDICATORS

	OCT. 14	WEEK AGO
S&P 500 200-day average	938.7	934.9
Stocks above 200-day average	84.0%	84.0%
Options: Put/call ratio	0.67	0.69
Insiders: Vickers NYSE Sell/buy ratio	5.49	5.23

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Internet Software	19.5	Internet Software	157.5
Divsfd. Metals & Mining	17.0	Divsfd. Metals & Mining	141.8
Home Entertainment	16.6	Compr. Stge. & Perphs.	119.9
Homebuilding	15.1	Wireless Services	102.3
Footwear	14.7	Internet Retailers	95.6

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Japan	9.6	Technology	69.2
Diversified Pacific/Asia	7.0	Latin America	66.0
Diversified Emerg. Mkts.	7.0	Precious Metals	61.4
Real Estate	6.0	Diversified Emerg. Mkts.	55.4
LAGGARDS		LAGGARDS	
Health	-1.3	Domestic Hybrid	16.4
Domestic Hybrid	1.7	Miscellaneous	18.4
Utilities	1.7	Large-cap Blend	19.5
Large-cap Growth	2.0	Large-cap Growth	20.7

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
J.P. Morgan Fleming Jap. A	19.0	Jacob Internet	224.5
Rsv. Pr. Intl. Sm. C. R	16.7	Apex Mid Cap Growth	207.9
Third Millennium Russia	16.4	ProFds. Intnet. Ultz. Inv.	203.3
CGM Realty	16.3	iShares Gold. Sachs Ntwkg.	154.8
LAGGARDS		LAGGARDS	
ProFunds UltSh. OTC Inv.	-6.6	Rydex Dynam. Vent. 100	-65.5
Rydex Dynam. Vent. 100	-6.6	ProFunds UltSh. OTC Inv.	-65.4
Ameritor Investment	-5.4	Frontier Equity	-54.4
PFds. Pharmctcls. Utr. Inv.	-4.8	Potomac OTC/Short Inv.	-40.2

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Photographic Products	-18.5	Health-Care Facilities	
Tires & Rubber	-5.9	Photographic Products	
Intgrd. Telecomms. Svcs.	-5.7	Brewers	
Brewers	-4.6	Health-Care Distributors	
Biotechnology	-4.5	Motorcycles	

INTEREST RATES

	OCT. 15	WEEK AGO
KEY RATES		
Money Market Funds	0.62%	0.62%
90-Day Treasury Bills	0.92	0.90
2-Year Treasury Notes	1.76	1.62
10-Year Treasury Notes	4.40	4.24
30-Year Treasury Bonds	5.29	5.16
30-Year Fixed Mortgage†	5.98	5.99

†Bank of America

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	10-YR BOND
General Obligation	5.90%
Taxable Equivalent	5.57
Insured Revenue Bonds	3.80
Taxable Equivalent	5.43

THE WEEK AHEAD

LEADING INDICATORS Monday, Oct. 20, 10 a.m., EDT » The Conference Board's September leading indicators index is forecast to have inched up by 0.1%. That's according to the median forecast of economists surveyed by MMS International. In August, the index increased 0.4%.

TREASURY BUDGET Wednesday, Oct. 22, 2 p.m., EDT » The federal government will probably close out fiscal year 2003 with a

\$25 billion deficit for September, following a \$76.5 billion deficit posted for August. The expected September deficit would push the full shortfall for fiscal 2003 to \$425.5 billion, a bit less than the government's forecast of a \$455 billion deficit, but far above the fiscal 2002 amount of \$157.8 billion.

INITIAL UNEMPLOYMENT CLAIMS Thursday, Oct. 23, 8:30 a.m., EDT » New filings for state

unemployment claims are expected to stand at 380,000 for the week ending Oct. 18. Initial claims are showing some hopeful signs. The four-week moving average for jobless claims is below the key 400,000 level, usually considered an indication that the labor market is stabilizing or improving. However, the number of continuing claims remains high, and current expectations are for a slow revival of the labor market.

The *BusinessWeek* production index climbed to 202.8 for the week Oct. 4, up 5.7% from a year before. Before calculation of the four-week moving average, the index inched to 203.2.

BusinessWeek ON

For the BW50, more invest data, and the components of the production index visit www.businessweek.com/magazine

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High Net Worth investors

Back in Business >>>

As 2003 draws to a close, the investment climate looks brighter than it has in years. The bear market that has so dominated lives and attention since the Internet on in 2000 has started to dissipate, and worth individuals are beginning to return traditional investment inclinations—along by rebounding stocks, a strength-recovery, and favorable new tax laws. The most recent market analysis by the investment firm Smith Barney is illustrative of this sentiment. "Prospects for the American economy in 2003," the analysis states, "appear to be improving significantly." Research by Bank of America Investment Services and KeyCorp's National Financial Group similarly indicates that wealthy Americans are growing more optimistic about the U.S. economy, with 55% of

affluent Americans surveyed in July expecting the economy to improve over the next three months, up sharply from just 45% saying the same thing in April.

Facing these economic improvements, wealthy investors are a dramatically changed group, considerably more analytical, more conservative, and more focused on long-term security than in the past.

A new survey by The Phoenix Companies, Inc. and Harris Interactive confirms just how much their perspective has changed. According to the firms' annual Wealth Survey, 43% of the wealthy now consider themselves "more savers than investors." More than half (57%) admit that their years of excess spending are long gone and 58% now believe that it's important to preserve the safety of their capital, even if it results in lower returns. (continued on next page)

>>>
Prospects for the American economy in 2003, appear to be improving significantly

DO YOU HAVE AN ESTATE PLAN FOR A LIFE YOU NO LONGER LEAD?

THINK ABOUT HOW MUCH YOUR LIFE HAS CHANGED OVER THE PAST FEW YEARS
HAS YOUR ESTATE PLAN KEPT UP?

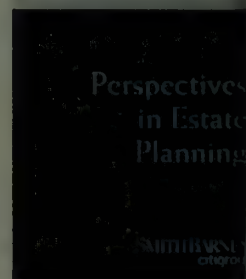
Smith Barney Financial Consultants know that an estate plan is really a plan for life. That's why we challenge you. Question you. Get to know you. Because your estate plan needs to:

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More Conservative Approach >>>

A change in attitude appears to be one of degree rather than a fundamental shift, however. According to a report by Spectrem Group, a Chicago-based financial consulting firm specializing in high net worth investors, "while it would seem reasonable for investors to abandon the stock market altogether, most affluent investors have merely modified their financial behavior, becoming more conservative or seeking new ways to diversify their portfolio." Investment advisors have catered to this desire by "ratchet[ing] their clients' risk downward," a move reflected in the fact that almost 80% of wealthy investors relying most heavily on advisors have become more cautious in the previous year.

Focus on Security >>>

Caution notwithstanding, wealthy investors appear to move back into the markets in a deliberate if conservative fashion. "The wealthy are no longer risk averse and fear when it comes to their finances," asserts Sherry, senior vice president of The Phoenix Company. "They've learned that trees don't grow to the sky, and want to move forward with a pragmatic approach." This conclusion is buttressed by a separate Spectrem survey in which surveyed investors were increasingly seeking alternatives to the broad market, "including alternative holdings like gold or real estate." Affluent investors' interest in non-stock market driven investments, Sherry notes, "has climbed dramatically from 11% in 2001 to 19% in 2003."

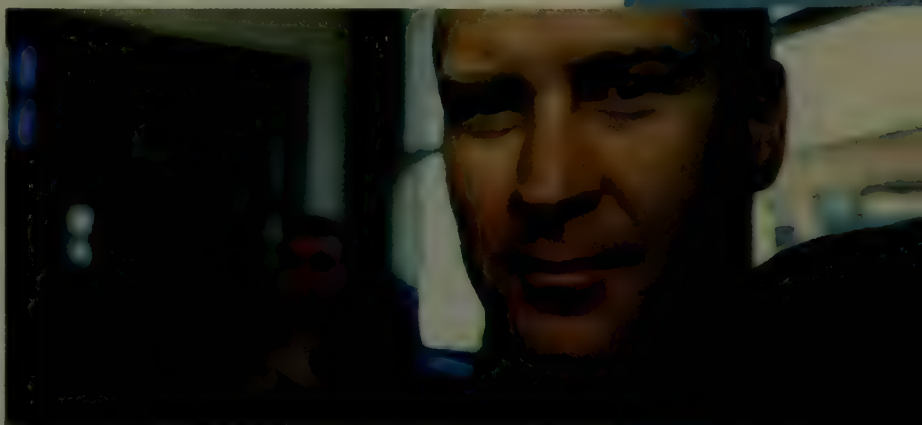
One key reason for this shift in investment strategy is the growing focus that high net worth investors are placing on security and retirement. In the Phoenix/Harris Interactive Wealth Survey, a growing percentage (33%) of wealthy investors feel that they need to make up for lost savings for retirement, and 63% say that the assurance of a comfortable standard of living during their retirement is their most important financial goal.

Despite the rising interest in alternative investments, high net worth individuals are becoming eager again to return to traditional stock and bond markets. Altogether, according to the Phoenix/Harris Interactive Wealth Survey, 49% of the wealthy say that they are interested in

obtaining stocks, 35% in purchasing mutual funds, and 33% in obtaining bonds in the near future in order to help them to achieve their financial goals.

Growing Reliance on Advisors >>>

Increasingly, these individuals are also relying more heavily on financial advisors for assistance in planning their investment decisions. While dependence on advisors has risen only slightly (from 56% to 59%) among investors with between \$1 million and \$5 million in investable



assets, the Spectrem Group discovered that the percentage of pentamillionaires (those with more than \$5 million in assets) relying on advisors has grown sharply since 2001, climbing from 57% to 69%.

Additionally, wealthy investors are turning to more sophisticated investment techniques, many of which demand the resources and expertise of professional advisors, in order to help them to surmount economic trouble spots. One such approach, called "tactical asset allocation," is being aggressively deployed by such firms as J.P. Morgan Chase & Co., Deutsche Bank, and Bank of America. The premise is that, by basing investment decisions on predictions for changes in the macroeconomy rather than on just the client's individual risk tolerance or future goals, advisors can generate more stable and secure long-term returns for their clients.

Regardless of the particular strategy being pursued, however, what is clear is that high net worth investors are back in the investment business in a major way. But it's a decidedly more conservative, more security-focused, and more advisor-reliant business than it once was. "The bear market certainly took a toll on American's financial future, and the wealthy and high net worth are no exception. It's clear this group now wants to take a realistic approach to re-coup their losses and make a comfortable future a reality," concluded Sherry of Phoenix. ■

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The Companies

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

A

ABC (DIS) **86**
 ABN Amro **56**
 Accuweather **110**
 adidas-Salomon **90**
 Adobe Systems (ADBE) **106**
 ADT Security (TYC) **140**
 Alaska Airlines (ALK) **132**
 Alfa Group **118**
 Allied Domecq (AED) **90**
 Alza **84**
 American Century Investment Management **49**
 American Express (AXP) **126, 134**
 America Online (TWX) **52**
 Amoco (BP) **118**
 Apple Computer (AAPL) **48**
 Archipelago **49**
 Ariba (ARBA) **101**
 ASML (ASML) **82**
 AT&T Wireless (AWE) **110**

B

Bain **43**
 Bank of America (BAC) **64, 104**
 Bank One (ONE) **52**
 Barclays Bank (BCS) **106**
 Baxter International (BAX) **100**
 Bayer (BAY) **20**
 BellSouth (BLS) **110**
 Blockbuster (BBI) **64, 88**
 BMW **116**
 Boston Consulting **64**
 BP (BP) **118**
 British Airways (BAB) **132**

C

Cambridge Energy **118**
 Campbell Soup (CPB) **52, 116**
 Canary Capital Partners **52**
 Candide Media Works **110**
 Cathay Pacific **132**

CBS (VIA) **86**
 Chef America **56**
 ChevronTexaco (CVX) **118**
 CIBC World Markets (BCM) **134**
 Cingular Wireless **110**
 Citigroup (C) **49, 52**
 Coca-Cola (KO) **56, 70, 90**
 Coinstar (CSTR) **100**
 Collaborative Economics **40**
 Comcast (CMCSA) **88**
 Commerzbank **116**
 Concur Technologies (CNQR) **101**
 ConocoPhillips (COP) **118**
 Containerless Research **82**

Cornice **48**
 Creative Labs **48**

D

DaimlerChrysler (DCX) **44**
 Def Jam **90**
 Dell (DELL) **48**
 Deutsche Bank (DB) **12, 118**
 Deutsche Telekom (DT) **116**

DigitalGlobe (DGTGP) **14**
 DirecTV (GMH) **86**
 Dresdner Kleinwort **118**
 Dreyer's Grand Ice Cream (DRYR) **56**
 DuPont (DD) **82**

E

Eli Lilly (LLY) **70, 84**
 EMC (EMC) **40**
 Enron (ENRNQ) **26, 104**
 Ernst & Young **110**
 Ethel M. Chocolates **138**
 Euro RSCG Worldwide **90**
 Expedia (EXPE) **134**
 Exxon Mobil (XOM) **118**

F

FedEx (FDX) **108**
 Fidelity Investments **49**
 Ford (F) **44, 49, 55, 152**
 Four Seasons **126**

Fox (FOX) **86**
 FTI Consulting (FCN) **101**
 FUBU **90**
 FunMail **110**

G

Gap (GPS) **90**
 General Electric (GE) **49**
 General Motors (GM) **40, 44, 45, 90**
 GlaxoSmithKline (GSK) **70**
 Goldman Sachs (GS) **102, 104, 106**
 Grey Worldwide **70**
 Grimaldi **90**
 Group Danone (DA) **56**

H

Harley-Davidson (HDI) **52**
 Hess Energy Trading (AHC) **118**
 Hewlett-Packard (HPQ) **12**
 Hilton Hotels (HLT) **126**
 Hollywood Video **88**
 Home Depot (HD) **64**
 Honda (HMC) **44, 152**
 Hyatt **126**

I

IBM (IBM) **40, 49, 106**
 ICG (ICGX) **110**
 ICOS **70**
 IMS Health **70**
 Inco (N) **102**
 inDemand **88**
 Intel (INTC) **40**

J

Japan Airlines **132**
 J.C. Penney (JCP) **90**
 J.D. Power **44, 152**
 JetBlue Airways (JBLU) **84**
 Johnson & Johnson (JNJ) **140**
 John Wiley & Sons **14**
 JPMorgan Securities (JPM) **40**

K

Kellwood (KWD) **90**

Kimpton Hotel **126**
 Kraft Foods (KFT) **56, 116**

L

Legg Mason **110**
 Lehman Brothers (LEH) **48, 70**
 Liebherr **116**
 LiveBridge **43**
 l'Oréal **56**
 Lucent Technologies (LU) **110**
 Lufthansa **132**
 Lukoil (LUKOY) **118**

M

MarketStar (OMC) **134**
 Marriott (MAR) **126**
 Mars **56, 138**
 Mastermind Group **90**
 McDonald's (MCD) **90**
 MCI **100**
 Mercer Management **132**
 Merrill Lynch (MER) **12, 40, 64**
 Meta Group **101**
 MGM (MGM) **88**
 Michelin **58**
 Microsoft (MSFT) **32, 48, 106, 108**
 Moody's (MCO) **118**
 Morgan Stanley (MWD) **104**
 Morningstar **138**
 Motorola (MOT) **52, 90, 140**
 Musicmatch **48**

N

Nantero **82**
 Nestlé **56**
 Nielsen//NetRatings (VNUVY) **86**
 Nike (NKE) **90**
 Nokia (NOK) **52**
 Nortel Networks (NT) **110**
 Northern Trust (NTRS) **102**
 Northwest Airlines (NWAC) **132**
 Novartis (NVS) **84**
 NPJ Group **48, 90**
 Old Navy (GPS) **64**
 Olive Group **130**
 Oppenheimer Real Asset Fund **102**

O

Oracle (ORCL) **101**
 Orbitz **134**
 O2 **116**

Pathmark (PTMK) **64**
 PeopleSoft (PSFT) **101**
 PepsiCo (PEP) **56, 90**
 Pfizer (PFE) **70**
 Phat Farm **90**
 Pictet **56**
 Polo Ralph Lauren (RL) **90**
 Potamkin Auto **64**
 PricewaterhouseCoopers **64, 88, 126**

Prime Hospitality (PDQ) **142**
 Procter & Gamble (PG) **70**
 Proview International **52**
 Pyramid Research **116**

Q

Qwest (Q) **110**

R

Ralston Purina **56**
 Reebok (RBK) **90**
 Renault **58**
 Revere Copper Products **102**
 Reynolds & Reynolds **16**
 Ritz-Carlton **126, 130**
 R.J. Reynolds (RJR) **20**
 Robert Half International (RHI) **101**
 Roc-a-Fella Enterprises **90**
 Royal Dutch/Shell (RD) **118**
 RSA Security (RSAS) **82**
 Rush Communications **90**

S

Salesforce.com **134**
 Samsung **48, 52**
 Sana Security **82**
 SAP (SAP) **101, 106**
 SBC (SBC) **110**
 Seagate Technology (STX) **12**
 Sears (S) **90**
 7-Eleven **90**
 Shire Pharmaceuticals **84**
 Shorenstein **12**
 Sidanco **118**
 Singapore Airlines **132**
 Sontra Medical (SONTC) **20**
 Sony (SNE) **90, 142**

SorosCredit **12**
 Space Imaging **110**
 Sprint (FON) **110**
 Standard & Poor's **138**

Standard Register **106**
 Starbucks (SBU) **110**
 Starwood Hotels & Resorts (HOT) **110**
 Stata Labs **32**
 Steinberg Global Management **140**

T

3M (MMM) **140**
 Time Warner (TWX) **110**
 TJX (TJX) **142**
 T-Mobile (DT) **110**
 TNK **118**
 TNS Media **70**
 Tommy Hilfinger **110**
 Toshiba (TOSBI) **110**
 Toyota (TM) **44**
 Travelocity.com **110**
 Tyco (TYC) **140**

U

Unilever (UN) **56**
 United Technologies **100**

V

Vanguard Group **110**
 Verizon (VZ) **110**
 Viacom (VIA) **140**
 Virgin Atlantic **110**
 (DLAKY) **132**

W

Wachovia Securities **110**
 Wal-Mart Stores **20**
 Walt Disney (DIS) **110**
 Warner Bros. (T) **110**
 Wendy's (WEN) **110**
 Winchester Capital **110**
 WorldCom **100**
 World Travel BT **110**
 Wyndham International (WBR) **126**

Y

Yankee Group **110**
 YukosSibneft **110**

Z

Zalco **102**

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A Turning Point For the Economy

SUDDENLY, THINGS ARE looking up. Corporate profits are surging, the stock market is levitating, confidence is returning—and even tax revenues are beginning to rise. With the economy going gangbusters, the unprecedented past two years of massive job losses in the face of rising economic growth is probably at an end. But a quick rebound in jobs should not be taken for granted, especially by those in the 2004 Presidential campaign. This time around, the U.S. is having not just cyclical joblessness but permanent job destruction (page 40).

People thrown out of work are taking substantially longer to find new work. Most of their old jobs are gone forever, and they will need to jump to different industries, perhaps entirely unrelated ones, to replace them. As demand picks up and companies lose their strong reluctance to hire, the economy will eventually generate many jobs. But millions who suffer from job destruction will require extra training and schooling to retrofit them into new careers.

The biggest job losses, of course, have been in manufacturing. Employment in factories peaked at 19 million in 1979. In every business cycle since then—except the current one—sharp declines in jobs during recessions were followed by stability during expansions. Manufacturing fell gradually, until the decline went into free fall with the recession of 2001. Even

in the third quarter, with growth in gross domestic product running at 6% to 7%, factory jobs disappeared.

What's different this time around? Sharply rising productivity and "offshoring" of factories to China. Past business cycles saw productivity fall as the recovery picked up and companies hired more people. This time, productivity

As factory work flees to China, the U.S. needs fresh job creation

growth actually accelerated, allowing corporations to accomplish more with fewer people, and boosting profits. Companies sent production offshore even as growth returned. With its network of supplier, reliable energy, and able workers, China makes it easy for manufacturers to move.

America is clearly moving into unknown economic territory, a tradeoff between productivity and job growth that has characterized

this business cycle may soon end in the heat of strong economic growth. In the months ahead, we could see a replay of the '60s and '90s when high productivity was matched by massive job creation to spread prosperity throughout society. Sustained growth of 4% or more could generate enough demand that it draws in all able-bodied workers, including those from dying industries. That's what happened in the '90s.

But there is a chance that job destruction overwhelms job creation. Rising productivity combined with outsourcing spread from manufacturing to services, impairing jobs. Goldman Sachs predicts that up to six million service jobs could move offshore over the next decade.

It would be prudent for policymakers to start thinking about helping people find the education and training to start new careers. The tide is clearly rising. We should make sure everyone gets into the boat.

It's Hybrid Time. Where's Detroit?

THE U.S. NEEDS to cut its dependence on Mideast oil. There is hybrid-engine technology that can help do just that. And there are consumers who want to buy cars powered by those engines. But the only carmakers willing to manufacture them are Japanese: Toyota and Honda. Ford has delayed the launch of its first hybrid-powered vehicle, the Escape SUV, until 2005, while Toyota is about to sell its next-generation hybrid, the new Prius sedan. It's time for Detroit to get on the stick.

The Big Three should stop spinning dreams of hydrogen-powered autos and embrace the hybrid gas-and-electric engine

that can save fuel now (page 44). Detroit is correct in saying that hybrids don't yet make money: The technology adds \$3,000 to the price of every car. But greater volume will offset that cost, and there are clear signs that consumers want more cars. The Prius, which goes on sale in November, is already out at many dealerships. The sedan is the same size and as fuel-efficient as a midsize Toyota Camry and gets about twice the miles per gallon. J.D. Power & Associates Inc. believes Detroit could produce hybrid sales of 500,000 vehicles in five years.

Washington could compress that time line. To expand hybrid volume and drop the cost, the government could order Detroit for its own huge fleet of cars and trucks. The military could develop hybrids for its Humvees and armored vehicles. Washington already offers a \$2,000 tax deduction to purchasers of hybrid cars. Turning that deduction into a credit would encourage corporate fleet owners to buy hybrids. Consumers would get a bigger tax break, too. Hybrid expansion would allow Detroit to sell the big SUVs and vans that most Americans prefer while still increasing mileage. The proposed energy bill before Congress is mostly devoid of measures to conserve energy and raise mileage. By promoting hybrid legislation could do both.

